Price/Earnings Ratio

By SIMON CONSTABLE

The price of a stock doesn't tell you anything about whether it's a good deal, but the so-called price/earnings ratio can help. The trick is figuring out which P/E ratio to use.

Obviously, just because one stock is $200 a share and another $12 doesn't mean the latter is cheaper in terms of what you're getting. For a better gauge, you need to calculate what you are paying for each dollar of company earnings. Hence, the P/E ratio, derived by dividing the price of the stock by one year of per-share earnings. So if one stock has a P/E of 12 and the other of 10, the latter is cheaper.

"Low P/E stocks outperform high P/E stocks," says Jeff Mortimer, director of investment strategy at BNY Mellon Wealth Management, a unit of Bank of New York Mellon Corp. "It does work over time with a broad basket of names."

But the simple P/E ratio is just a starting point. You also can calculate a "forward" P/E, using average analyst estimates for future earnings. That provides an indication of what the average investor is prepared to pay for future earnings. A high forward P/E, though, can mean a couple of things. It could be that investors are willing to pay up for a stock because they expect earnings to grow at a rapid clip. Or it could be they've simply gotten carried away in a frothy market.

Another wrinkle: Estimated earnings may be unrealistic.
"You can make the forward P/E anything you want [by boosting the forecast]," says Mr. Mortimer.

He prefers to calculate a "trailing" P/E based on the last four quarters of results, adjusted for unusual gains and charges. Deciding what to exclude can get tricky, but generally items that aren't likely to be repeated are left out.

That way, investors can get an idea of what the business earned from operations before relatively unusual events like plant closings.

Of course, historical earnings may not tell you much about where a company is headed. Think about the hit the uranium industry took following the 2011 Fukushima nuclear disaster in Japan. The prior 12 months of earnings and the resulting P/E would have given you little clue about how to invest.

That's partially why investors shouldn't rely solely on P/E when making a decision to buy or sell a stock. Not only are there other metrics (like price-to-cash-flow, or price-to-sales), but there are also qualitative factors to consider. Smart money managers weigh things like the overall strength of the economy, the profitability of an industry and the track record of a company when deciding whether to invest in a specific stock, according to a recent report from Morningstar Inc.

And what about a company that's posting losses? In that case forget the P/E calculation. It doesn't apply.

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