Chart 1

Price/Earnings Ratios: Then and Now

I bet you'd bet that price/earnings ratios (P/Es) were sky-high in 1929. You lose. They were no higher than in the 1986–1987 stock market. That's scary. Why? When a stock price is high in relation to a company's earnings, the stock is usually overpriced. When all stocks are high-priced in relation to earnings, the market is usually ripe for a rip-roaring retreat. You know what happened after 1929. Almost every other time P/Es were this high, the market has done poorly too. With the Dow Jones Industrials averaging 19 times earnings in 1986, this graph was crying out a shrill warning from my dusty library shelves.

The graph came from a 1975 research report issued by the brokerage firm of Goldman Sachs. There is nothing unique about it except its simplicity. The Value Line graph (Chart 11) gives greater detail on P/Es, but is harder to draw conclusions from due to its added clutter. What you do see right off is that only a few times has the market sold at P/Es greater than 20, which is marked with a heavy horizontal line. Instead, most of the time, the market sold for less than 15 times earnings.

A great irony is that at the market's best buying points, before the rise in the 1920s and again before the rise coming out of the Great Depression, P/Es were sky-high—essentially infinite—because there weren't any earnings, as you can see on the accompanying chart. But it's rare, and it isn't the world we're facing as this book is coming to print.

Were P/Es sky-high in 1929 the way legend would lead you be believe? No way! That's part of why so many folks got fooled into holding their stocks going into the greatest slide ever—they didn't think stocks were too expensive. A most interesting point is that P/Es weren't any higher in 1929 than in 1986. If P/Es have usually been less than 15, this chart is an extreme warning sign for the current stock market.

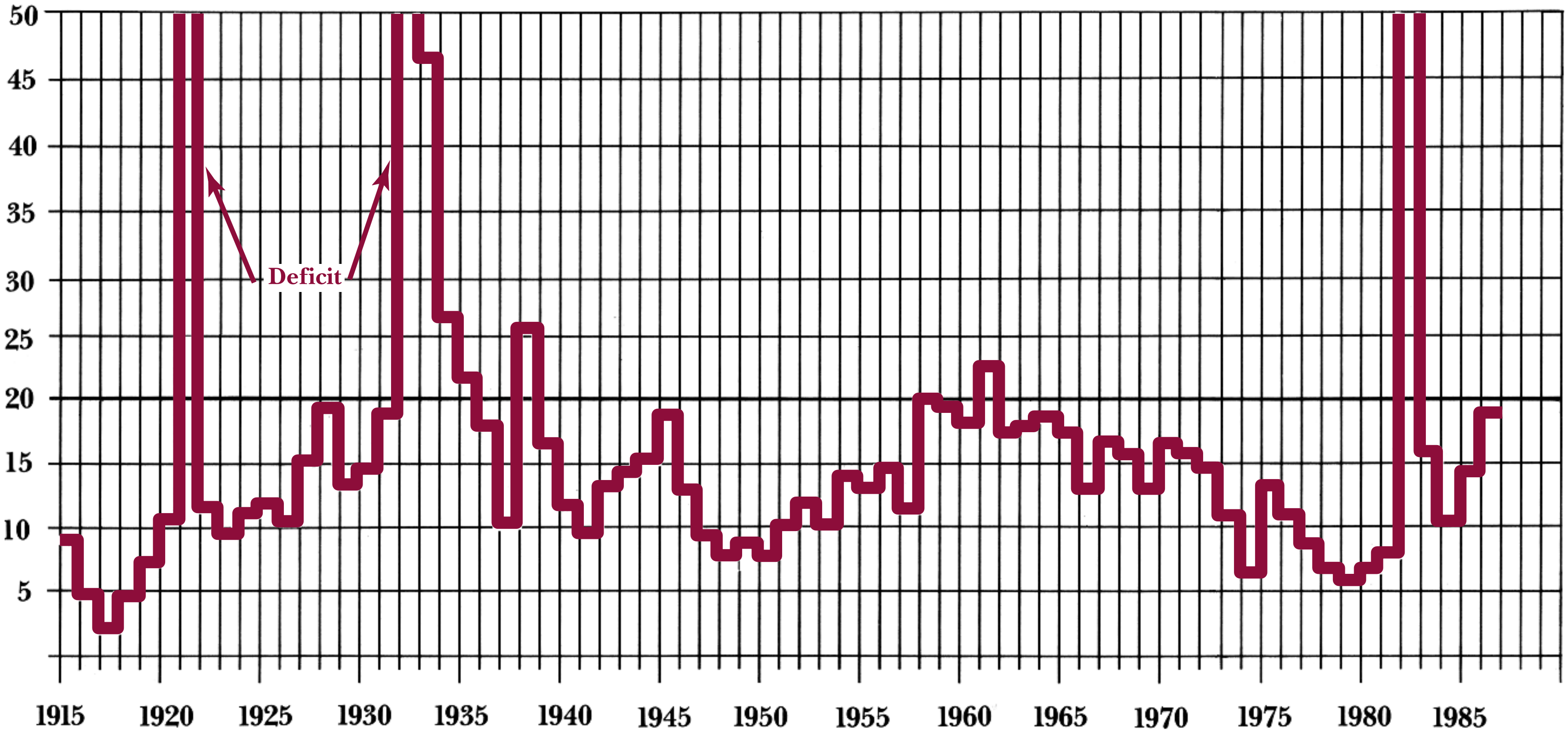
What I'd Say Today

Though this old chart looks convincing, P/Es aren't remotely predictive! This is great evidence of why you must always question what you believe, particularly since old data can be dirty data. Using publicly available, free information and an Excel spreadsheet, you can easily prove for yourself P/Es—high, low, or middling—predict neither future risk nor return.

My recent book, *The Only Three Questions That Count,* covers this in depth, but simply: Sometimes high P/E markets do well and sometimes they do badly. Generally, when P/Es are high and people are scared to death, markets keep doing well, as they did in the 1990s' latter half. When P/Es are high and folks aren't fretting it, that can be bearish. Similarly, when P/Es are low and people see that as bullish, it isn't. Today, it depends on how people react to P/Es because they're now a widely known bit of information and largely discounted into pricing. But sentiment regarding the market's P/E may not be so well identified and discounted.

At the same time, equities compete with long-term fixed income for investor dollars, so when P/Es are high but long-term interest rates sustainably low, a higher P/E may be justified. The admonition at the end of my original commentary here, saying 1987 P/Es were "an extreme warning sign," worked because throughout 1987, long-term interest rates were very high and rising, culminating in the Crash of '87. But you can't think about P/Es correctly without considering comparable long-term interest rates and overall sentiment regarding the market's valuations.

Dow Jones Industrials Price/Earnings Ratio, 1915–1986



Source: 1915–1975, Goldman Sachs & Co., Gary Wenglowski; 1975–1986, data from Dow Jones & Co.