

Expert View

The P/E Problem

By William W. Priest, electronically reprinted from October 29, 2009

Investors' obsession with price earnings multiples is misguided. Here's why.

With companies reporting third-quarter earnings, Wall Street is abuzz with analyst updates and revised earnings outlooks. No doubt this will lead to some big changes in price-to-earnings ratios. After all, P/E ratios receive a lot of attention from the media and stock analysts because they are ubiquitous and easy to understand. From Maria Bartiromo and Jim Cramer to your next door neighbor, P/Es have become ingrained in Wall Street's vernacular. And judging by the how often you hear P/Es touted, you would think they are the most important measure of a company's value. They're not.

For the 20-year period from 1980 to 2000, P/E ratios quadrupled, providing almost half of the total equity return realized over that time span (see table below). The declines in inflation and interest rates were the principal factors responsible for this explosion in P/E values. Interest rates dropped from a high of more than 13% in the early 1980s to less than 4% by 2000. In other words, the cost of capital plummeted

throughout this period, and P/E ratios, the reciprocal of the cost of capital, soared.

The two other contributors to equity returns—earnings growth and dividend yield—also contributed to total equity return during this 20-year stretch, but they mattered less to overall growth than P/E ratios.

Today, the opposite is true. Going forward, P/E multiple expansion is

common stocks for the foreseeable future.

Another problem with P/Es as a valuation tool has to do with accepted accounting practices according to Generally Accepted Accounting Principles (GAAP). Over the past 20 years, GAAP has become less informative of the true financial health of a business. Although the GAAP system has been somewhat effective in enforcing a greater level of accountability and standardization within corporate financial reporting, the beneficial intentions of this process have become obfuscated. In fact, GAAP standards are now so intricate and complicated that their utilization is fraught with pitfalls for both management and investors.

At the heart of a value investor's analysis is the assumption of an expected stream of earnings to be derived from the net assets of a company. But the problem is that the accountant's definition of the estimated useful life of an asset can be very different from an investor's definition.

1980 → 2000	
P/E's	7.6%
Earnings	6.4%
Dividends	<u>3.6%</u>
Annualized Return ¹	17.6%

1980-1999 S&P 500 total return.

unlikely to occur unless interest rates start trending downward. With the federal funds rate already at or near zero, that prospect is unlikely. Thus, I believe, P/E ratios won't contribute much to equity returns going forward. Dividends and earnings are likely to account for nearly all of the returns in

For example, one accounting concept that distorts financial realities is the principle of depreciation. To the accountant, depreciation is the allocation of the cost of an asset over the expected useful life of the asset. Consider airplanes. According to accounting conventions, an airplane has a fixed life of approximately 10-15 years. However, many commercial jets remain in the air long after that period of time. Or consider the case of a manufacturing firm that builds a new plant with an estimated life of 30 years, only to learn a year later that the widgets the plant was built to produce have become obsolete. In both cases, the values derived from accounting conventions are inconsistent with the economic reality.

By contrast most value investors use a present value approach to price assets. Present value analysis contends that the current value of an asset is best determined by discounting the cash flows expected to be derived from the asset by the firm's cost of capital. Therein lays one of the key shortcomings of traditional accounting: there is no allowance for a change in the cost of capital in the accountant's methodology, even though it is incredibly relevant to an asset's value.

That is where discount rates come in. In finance, investors address changes in the cost of capital by incorporating the two interrelated factors, inflation and interest rates. After all, the true value of the annual depreciation charge of an asset is not immune to changes in interest rates. In other words, depreciation should not be the same when interest rates are 8% as it is when rates are 4%. Accounting ignores these critical details while finance incorporates them by using cash flow metrics rather than earnings metrics and a cost of capital measure that reflects current interest rates plus a component for a company's overall riskiness.

Another reason for the fundamental unreliability of P/E-based valuation metrics is the ratio's demonstrated volatility. While earnings almost always rise over time, P/E ratios fluctuate, rising in some years and falling in others. These fluctuations occur because inflation expectations drive long-term interest rates, and long-term interest rates are the discount mechanism for future cash flows and earnings and hence the primary determinant of P/E ratios.

P/E ratios have an inverse correlation with interest rates of approximately minus 0.8. Hence, P/E ratios fall when rates rise and rise when rates fall. Given the current economic outlook, flat or rising interest rates seem almost a given in the foreseeable future. This presents a problem for P/E ratios and P/E watchers.

Some may call it heresy, but any methodology subject to so much variation, imprecision and even manipulation should not form the basis for equity valuations. That's why P/E ratios carry little weight at our firm, Epoch Investment Partners.

Here is a better way to value stocks: First, the investor should weigh the cost of capital against the firm's stream of current and future free cash flows to determine the asset's value. Then the investor uses financial analytics to identify the businesses and management teams that demonstrate an awareness of their cost of capital and have a history of deploying their free cash flow in a shareholder value creating fashion.

Free cash flow analytics are already at the heart of the corporate capital budgeting process and private equity capital allocations. Smart investors would be wise taking a page from these business owners and focus on cash flow.

If a firm can deploy the incremental dollar of cash flow at a rate of return

greater than its cost of capital, it should pursue acquisitions or internal capital projects, as these methods will be the fastest way to build shareholder value. Otherwise, that free cash flow should be returned to shareholders. There are three ways to accomplish this end: cash dividends, share buybacks and/or debt reductions. We define this total to be "shareholder yield." Especially in today's environment, with P/E ratios unlikely to rise given the present level of interest rates, it will be important to determine how much of the free cash flow generated within a firm actually ends up in shareholders' hands.

Oracle (ORCL), a large portfolio holding of my firm, is an excellent example of a company with a high proportion of "shareholder yield." For the fiscal year ending May 2009, Oracle reported accounting earnings of \$5.6 billion. At that time its market cap was just over \$106 billion, resulting in a P/E of 19 or an earnings yield of 5.3%. This ratio appeared to represent fair value for many investors. A closer look, however, revealed a much higher free cash flow yield as well a rising shareholder yield and a commitment to new business acquisitions that should be accretive to shareholder value. Oracle's free cash flow was \$7.7 billion or 7.2% of its market capitalization. More than 70% of that amount was returned to shareholders through share buybacks and a new cash dividend with the remaining 30% reinvested in the business through acquisitions and internal projects.

Free cash flow growth rates combined with shareholder yield measures will dominate equity returns going forward. Investors who rely on P/E ratios as their principle valuation metric do so at their peril.

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