42 What is price/earnings ratio

The price/earning (P/E) ratio is another measurement that's of particular interest to investors in public businesses. The P/E ratio gives you an idea of how much you're paying in the current price for stock shares for each dollar of earning. Earnings prop up the market value of stock shares, not the book value of the stock shares that's reported in the balance sheet.

The P/E ratio is a reality check on just how high the current market price is in relation to the underlying profit that the business is earning. Extraordinarily high P/E ratios are justified only when investors think that the company's earnings per share (EPS) has a lot of upside potential in the future.

The P/E ratio is calculated dividing the current market price of the stock by the most recent trailing 12 months diluted EPS. Stock share prices bounce around day to day and are subject to big changes on short notice. The current P/E ratio should be compared with the average stock market P/E to gauge whether the business selling above or below the market average.

P/E ratios are currently running high, despite a four-year slump in the stock market. P/E ratios vary from industry to industry and from year to year. One dollar of EPS may command only a $10 market value for a mature business in a no-growth industry, while a dollar of EPS in a dynamic business in a growth industry may have a $30 market value per dollar of earnings, or net income.

To sum up, the price/earnings ratio, or P/E ratio is the current market price of a capital stock divided by its trailing 12 months' diluted earnings per share (EPS) or its basic earnings per share if the business does not report diluted EPS. A low P/E may signal an underbalued stock or a pessimistic forecast by investors. A high P/E may reveal an overvalued stock or might be based on an optimistic forecast by investors.