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Does the Peg Ratio Rank Stocks According to the Market's Expected Rate of Return on Equity Capital?

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Abstract

The PE ratio divided by the short-term earnings growth rate (the PEG ratio) is often used to rank stocks. This ranking implicitly assumes that earnings growth will not change beyond the (short) earnings forecast horizon. I provide a means of simultaneously estimating the expected rate of return and the change in the earnings growth beyond the forecast horizon thereby refining the PEG ratio ranking. Although estimates of the expected rate of return based on the PEG ratio are downward biased, they are highly correlated with the refined estimates supporting the use of the PEG ratio as a parsimonious basis for stock recommendations. The downward bias is greater for firms with lower short-term earnings growth rates, higher PE,and higher ratio of price-to book value while the bias is lower for larger firms and firms with higher standard deviation of returns.

Keywords: PE ratio, PEG ratio, Earnings forecasts, Earnings growth, Cost of capital

JEL Classification: C53, E43, G11, G12, G31, M41

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