

Adjusting P/E ratios by growth and risk: the PERG ratio

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Purpose

The purpose of this study is to compare the performance of a low-P/E strategy relative to that of two alternative *value* strategies, one based on the PEG ratio and another on the PERG ratio (a magnitude introduced in this article).

Design/methodology/approach

The data used consists of a sample of 100 US companies between January 1975 and September 2002. Portfolios are formed on the basis of different valuation ratios, and their performance is compared in order to determine the best-performing strategy.

Findings

Portfolios sorted by PERG ratios outperform, on a risk-adjusted basis, those sorted by both P/E ratios and PEG ratios. This outperformance occurs regardless of whether portfolios are not rebalanced, rebalanced every ten years, or rebalanced every five years.

Research limitations/implications

The sample of stocks is not large. The results could be validated by using a larger sample of US stocks and a longer time period, as well as by using a sample of stocks from several international markets.

Practical implications

The PERG ratio proposed in this article improves on the PEG ratio, adjusting the latter by risk. That, plus the fact that PERG-based strategies outperform on a risk-adjusted basis strategies based on both P/Es and PEGs, should make it an attractive tool to add to the arsenal of valuation tools used by analysts.

Originality/value

A new valuation tool is proposed, called the PERG ratio, that adjusts P/E ratios by both growth and risk (or similarly, PEG ratios by risk).

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