

113 | 158

Views | CrossRef citations to date | 3

Altmetric

Research Articles

What Determines Price-Earnings Ratios?

William Beaver & Dale Morse

Pages 65-76 | Published online: 31 Dec 2018

“ Cite this article <https://doi.org/10.2469/faj.v34.n4.65>

CFA Institute members: [sign in to access the Financial Analysts Journal.](#)

Sample our
Law
Journals

>> [Sign in here](#) to start your access
to the latest two volumes for 14 days

“ Citations

Metrics

Reprints & Permissions

Read this article

Share

We Care About Your Privacy

We and our 887 partners store and access personal data, like browsing data or unique identifiers, on your device. Selecting I Accept enables tracking technologies to support the purposes shown under we and our partners process data to provide. Selecting Reject All or withdrawing your consent will disable them. If trackers are disabled, some content and ads you see may not be as relevant to you. You can resurface this menu to change your choices or withdraw consent at any time by clicking the Show Purposes link on the bottom of the webpage. Your choices will have effect within our Website. For more details, refer to our Privacy Policy. [Here](#)

We and our partners process data to provide:

Use precise geolocation data. Actively scan device

I Accept

Reject All

Show Purpose



by William Beaver and Dale Morse

What Determines Price-Earnings Ratios?

► Recent studies on the behavior of earnings growth over time raise doubt about the ability of past growth to explain differences in price-earnings ratios. Either future growth is difficult to predict, or investors are basing their predictions on information other than past growth.

Grouping common stocks into portfolios on the basis of price-earnings ratios, the authors find that the initial P/E differences among the portfolios persist up to 14 years. Growth appears to explain little of the persisting P/E differences, however. Price-earnings ratios correlate negatively with earnings growth in the year of the portfolio's formation, but positively with earnings growth in the subsequent year, suggesting that investors are forecasting only short-lived earnings distortions.

Nor does risk supply the explanation for these differences. Although price-earnings ratios can vary either positively or negatively with market risk, depending on the market conditions in a given year, market risk is of little assistance in explaining the observed persistence in price-earnings ratios over periods longer than two or three years.

The authors conclude that the most likely explanation of the evident persistence in price-earnings ratios is not growth or risk, but differences in accounting method. ►

THE PRICE-EARNINGS ratio (hereafter P/E ratio) is of considerable interest, yet little is known about how it behaves over time or about the relative importance of the factors believed to influence its behavior. Differences in expected growth are commonly offered as a major explanation for differences in P/E ratios. Yet recent research raises doubt about this interpretation; past growth and analysts' forecasts appear to have little ability to explain subsequent growth.¹ Using a portfolio ap-

proach, we examine the behavior of P/E ratios and explore the ability of earnings growth (hereafter growth) and risk to explain P/E ratio differences across stocks. We find that, although differences in P/E ratios persist for up to 14 years, growth and risk appear to explain little of this persistency. In particular, growth appears to have virtually no effect beyond two years.²

Valuation Theory

Under perfect markets and certainty, the price of a security is equal to the present value of the future cash flows. Over an infinite horizon, the current price will reflect the stream of dividends. Under the further assumptions of (1) a constant dividend payout ratio (K), (2) constant growth in earnings per share (g) and (3) a constant riskless rate (r), P/E is given by the Gordon-Shapiro valuation equation:

$$P/E = \frac{K}{r-g} \quad (1)$$

In a certainty world, earnings per share (E) can be defined as that constant cash flow whose present value is equivalent to the present value of the cash flows generated from current equity investment. Where the investment involves assets with finite lives, this definition implicitly reflects the fact that the value of the assets will depreciate over their lives.³ We adopt this definition, which is often referred to as permanent earnings. Absent further investment, or if the earnings rate on future investment

1. Footnotes appear at end of article.

William Beaver is Thomas D. Dee, II Professor of Accounting at the Graduate School of Business, Stanford University. Dale Morse is a Ph.D. candidate at the Graduate School of Business, Stanford. Financial support for their research was provided by the Stanford Program in Professional Accounting, the major sponsors of which are Arthur Andersen & Co., Arthur Young & Co., Coopers & Lybrand, Ernst & Ernst, Peat, Marwick, Mitchell & Co. and Price Waterhouse.



Log i



Log i

Log

Resto

Res


Purchase options *

Save for later

PDF download + Online access

- 48 hours access to article PDF & online version
- Article PDF can be downloaded
- Article PDF can be printed


EUR 48.00

 Add to
cart

Issue Purchase

- 30 days online access to complete issue
- Article PDFs can be downloaded
- Article PDFs can be printed

EUR 175.00

 Add to
cart

* Local tax will be added as applicable

Related Research



Information for

- Authors
- R&D professionals
- Editors
- Librarians
- Societies

Opportunities

- Reprints and e-prints
- Advertising solutions
- Accelerated publication
- Corporate access solutions

Open access

- Overview
- Open journals
- Open Select
- Dove Medical Press
- F1000Research

Help and information

- Help and contact
- Newsroom
- All journals
- Books

Keep up to date

Register to receive personalised research and resources by email

 Sign me up



Copyright

Accessib

Registered
5 Howick Pl

or & Francis Group
orma business

