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Do stocks with low price-earnings ratios outperform stocks with high price-earnings ratios? Some tests indicate that low P/E stocks do offer excess returns. Critics of these tests, however, contend that the higher observed returns are attributable, not to the P/E ratios, but to the small firm size and infrequent trading that tend to characterize low P/E stocks.

The authors control for the small firm and infrequent trading effects by including in their tests only frequently traded stocks of companies of a certain size. In addition, they control for another possible bias—the industry effect. Because firms in the same industry tend to cluster in the same relative P/E ranking, detected return differences between P/E groups may be attributable to industry performance, rather than P/E level. This bias is eliminated by using price-earnings relatives (PERs)—the index of the P/E ratio of a stock relative to its industry.

The results indicate that PER is a significant factor related to excess returns. Low PER portfolios tend to outperform high PER portfolios, as well as the sample mean. Furthermore, as PER increases, returns decline consistently.

THE RATIO of the market price of a stock to its annual earnings per share—the price-earnings (P/E) ratio—has long been one of the most observed indicators of stock value. Applying the appropriate P/E ratio to a company's four most recently reported quarterly earnings per share yields a quick estimate of the stock's fair market price. The P/E ratio presumably represents investors' collective opinion regarding a firm's future prospects and its riskiness. In this sense, the more favorable a firm's outlook, *ceteris paribus*, the higher the P/E ratio, and the higher the price investors are willing to pay. As early as 1949, however, Benjamin Graham contended that investors often overreact to corporate prospects, overpricing the most favorably viewed companies and underpricing the least attractive companies.[1] As a result, favorably viewed stocks tend to be assigned P/Es that are too generous, whereas the lackluster stocks receive meager multiples.

This article analyzes a special kind of P/E—one that is normalized to reflect industry considerations—and its ability to forecast security performance. We hypothesize that this industry-normalized P/E ratio, which we call the price-earnings relative (PER), is an indicator of future security returns. If Graham's contention is valid, then the lowest P/Es and PERs are presumably too depressed and should eventually adjust upwards to a more normal level, leading to higher than normal returns. On the other hand, the highest P/Es and PERs should at some time deflate to lower and more realistic levels, depressing returns on these stocks.

1. Footnotes appear at end of article.

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