Sionna Investment Managers®

INSIGHT

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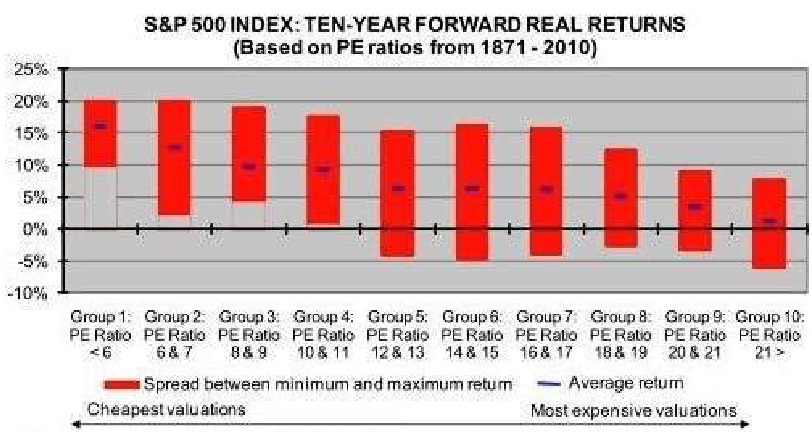
P/E Ratios – A Classic Predictor of Long-Term Returns

"Hence we may submit, as a corollary of no small practical importance, that people who habitually purchase common stocks at more than about 20 times their average earnings are more likely to lose considerable money in the long run."

Benjamin Graham and David L. Dodds are, hands down, the Shakespeares of the financial industry. For a couple of financial guys, they wrote beautifully and, like Shakespeare, their quotes were loaded with meaning and foreshadowing. Their classic – *Security Analysis* – is as profound today as it was when it was written almost 70 years ago in 1934 – in the midst of the Great Depression – no less. As lifelong students of Graham & Dodd's discipline, we keep a 1st edition copy of *Security Analysis* visible in Sionna's foyer as a constant reminder of their principles and techniques. It's timeless literature full of the classic value investing concepts that we use every day.

Take Graham & Dodd's classic price-to-earnings or P/E ratio. This simple but powerful ratio provides valuable insight into a stock's long-term potential. One of the basic tenants of value investing is that long-term returns of a company are directly correlated to the price paid for it. The P/E ratio measures how many years of current earnings would be required to pay for the current stock price itself: the lower the price paid for a stock, the higher the long-term returns and vice versa.

In the chart below, Plexus Asset Management demonstrates the relationship between P/E ratio at the time of investment and the long-term returns.



This analysis shows that paying an average P/E ratio of less than 6 times (Group 1) results in 10-year returns of between 9.5% and 20.0% with the average at 16.1%. Cheap price – high return. We see that paying less than 12 times P/E *always* results in positive long-term returns. And, just like Graham & Dodd said in 1934 – buying stocks with a P/E of 20 times, well, is just plain foolish.

Which brings us to the S&P/TSX Index today. The trailing P/E is currently in at 19.2 times, making the Canadian market expensive and very close to the Graham & Dodd "20 times" foreshadowing. We are using the Plexus Asset Management data from the U.S. as there are currently no similar long-term statistics available for Canada. Assuming this data can be applied to the Canadian market, P/E ratios in the range of 19 times are likely to achieve average 10-year returns of 5% per annum with a low of -2.6% and a high of 12.2%.

Is Sionna saying that the Canadian market is too expensive? Yes – but the good thing is we don't buy the index. We get to sift through it and select the individual securities with more attractive P/Es than the market. We do, however, caution cap-weighted index holders because, approaching the 20 times mark, the S&P TSX is also approaching Graham & Dodd's "foolish zone".

With our relative investing style, Sionna follows a broad range of Canadian stocks and we hunt for good companies at good prices. At present, we have selected a portfolio of inexpensive stocks and we remain confident that given enough time, these stocks should rise relative to the market. Our conservative estimate gives us confidence in our ability to generate superior long-term returns – despite the valuation of the overall market.

How did we manage to get our hands on that classic 1st Edition, 5th Printing, *Security Analysis* in the glass cabinet in our lobby, you ask? When I found out that a retired wholesaler friend, Doug Rodomar from the Canadian Investment Fund, had a 1st Edition copy, I expressed an interest in buying it. Doug, in a gesture I will always treasure, gave me that wonderful book at one of our annual lunches. Truly a classic by the Shakespeares of the financial industry.

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