POOR GROWTH GUIDE

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One of the most commonly used tools of the investment analyst is the Price/Earnings Ratio. The reason for the popularity of the P/E ratio is that at a glance an investor can make a comparison with an unlimited number of stocks on a common base. This use is further extended in attempting to estimate future share prices by applying a chosen P/E ratio to a figure for expected earnings in a number of years in the future, thus producing an estimated price per share.

Probably the most important single factor which influences the price of a share, and consequently its price earnings ratio, is the anticipation of growth of future earnings and dividends. The reason investors have pushed the price of shares in companies like WMC and BHP to record levels is not because of profits earned in the latest financial year, but in expectation of much higher profits in future years. At the same time, shares in companies which are engaged in industries which are not popular with investors as growth industries are given prices which are much closer to their earnings. We can say then that the price earnings ratio of a stock bears a strong relationship to expected future growth of earnings.

An article appearing in the Financial Analysts Journal (December, 1967) entitled "Price/Earnings Ratios and Future Growth of Earnings and Dividends" by Joseph E. Murphy Jnr., and Harold W. Stevenson examined the question of the relationship between P/E ratios and future earnings and dividend growth. Two groups of tests were made. In the first group of tests correlations were made between P/E ratios of selected companies in one period with growth of earnings and dividends of the same companies in a succeeding period. In the second group of tests companies were grouped into quintiles on the basis of P/E ratios in one period; then average rates of growth of earnings were computed for each quintile in succeeding periods. In the survey, 513 companies were tested and the test period covered the fifteen years 1950-1964.

In reporting the results of their survey, the authors conclude, "Contrary to current assumptions the P/E ratio, according to our tests, proved an unreliable judge of which companies would record superior growth of earnings per share."

It was decided to perform a similar but less complicated test on a representative number of Australian stocks to see if any conclusions could be drawn about price earnings ratios and future growth of earnings. Details of the test performed are as follows:—

Seventy-five leading Australian stocks were selected and their P/E ratios using 1959 financial year earnings and June, 1960 closing prices. In order to achieve uniformity in the test, the company financial year had to end between May 31 and September 30. The company had to be listed on a Stock Exchange at 30th June, 1960 and June, 1966. Companies selected were in the medium to large category. On the basis of their P/E ratios at 30th June, 1960 the companies were ranked accordingly from the highest to the lowest and divided into five groups numbered I to V. See Table 1.

The growth of earnings index was calculated for each company using 1959 earnings as the base. The earnings growth index from Australian Investments 1967 published by Wallace H. Smith & Co., February, 1967 was used. This is an index of the growth of earnings and is adjusted for bonus and cash issues. The indices for all the companies in each group were calculated and averaged to find the growth of earnings of the whole group from 1960 to 1966.

INDEX OF EARNINGS (BASE 1959=100)

	Av. P/E Ratio	1960	1961	1962	1963	1964	1965	1966
Group I	24	106	109	113	128	134	143	149
Group II	17	104	102	104	116	123	132	136
Group III	14	121	113	118	134	149	152	155
Group IV	12	121	112	112	131	159	165	164
Group V	10	116	100	103	122	144	156	150

The table shows that growth of earnings ranged from 36% to 64% over the seven years. However, the relevant point disclosed is that the percentage increase in earnings did not necessarily coincide with the rating of the groups. The highest price group did not show the greatest percentage growth of earnings and, in fact, superior rates of growth were recorded by the three lowest groups. The group which showed the highest rate of growth over the period was the fourth group and, in six of the seven years examined, this group showed a greater growth rate than Group I. It is interesting to note the disappointing performance of Group II. In five of the seven years this group showed the lowest growth rate and the overall growth percentage of 36% compares most unfavourably with Group V which achieved a 50% increase.

Although Group I did not record the greatest growth performance over the period, it deserves first place on the list for consistency. This group was the only one to show an increase in earnings each year, which, when considering the difficult times experienced in the 1960-1962 period, is a commendable effort. The other groups performed badly in this period; Group II showing no growth and the other groups recording a decline in earnings. Group V performed worst of all, but also showed the best recovery in the following four years. It was not until the 1963-1966 period that the significant gains were recorded by all groups, especially the three lowest groups. A further test was performed to see whether the high priced stocks were able to maintain their high P/E ratios over the period of the survey in view of their relatively disappointing growth performance.

It was found that only three of the stocks in Group I would have been included in that group had the test been based on P/E ratios calculated at 30/11/66. Two of the 15 stocks had fallen so much from favour that they would have been relegated to the lowest group. A similar test performed on the lowest group showed this group to be more stable as 11 of the stocks would remain in the group. Of the four which rose to higher levels, one would be included in Group I.

Conclusion

According to our tests the P/E ratio proves to be an unreliable indicator of future growth of earnings. The test reveals that there is little systematic relationship between relative P/E ratios in one period and relative growth of earnings per share in subsequent periods. Over the period of the study, Group I earnings showed less fluctuations from year to year than the lower groups. Group V earnings, on the other hand, showed relatively wide fluctuations and this may suggest that companies in the higher groups commanded a relatively high price because of investors' faith in their stability. We can, however, draw a conclusion from the exercise which is similar to that recorded in the American article which was "A high P/E ratio is not a prophecy of superior earnings growth nor is a low P/E ratio a portent of inferior earnings growth". This conclusion suggests that opportunities exist for investors to choose stocks that will show good future growth of earnings without the need for investors to pay a high premium attributed largely to expectations.

TABLE I (ALPHABETICAL ORDER)

GROUP I	GROUP II	GROUP III	GROUP IV	GROUP V
Adelaide Steamship	A.G.C.	A. & K. Cement	Adelaide Cement	Aldus
Ampol	A.P.P.M.	Big Sister	A.P.M.	A.R.C.
Castlemaine Perkins	A.W.A.	D. Syme	Assoc. Securities	A. V. Jennings
Coles	B.H.P.	Develop Fin. Corp.	B.H. South	Brownbuilt
Fairfax	Burns Philp	E.Z. Ind.	B.M.I.	Cleckheaton
Herald	C.U.B.	Humes	Boral	Dunlop
I.C.I.A.N.Z.	David Jones	Johns & Waygood	C.I.G.	Ensign
Loloma	D.H.A.	Mayne Nickless	Custom Credit	J. McIlwraith
Mauri	Gerrard	Metro Dairies	E.M.I.	Lifesavers
Mt. Isa	J. Gadsden	McPherson	G.U.D.	Noske
Petersville	Myer	News	H. H. Webb	Olympic
Pioneer Concrete	Myttons	Qld. Press	Minster	Overseas
Rocla	National Bank	Waltons	North B.H.	Rothmans
Sleigh	National Consol	Wilke	Repco	Softwood
Union Carbide	Television Corp.	W. R. Carpenter	Tom Piper	Western Mining