"Price Earnings Ratio (P/E) – Let's Learn to Use it and not Abuse it!" – *Nov 2020*

As investors, we must always question ourselves, are we using the high PE ratio as an excuse to not dig deeper to analyse great leading businesses? By overcoming this apprehension, one can not only significantly improve the chances of owning leading franchises but also dramatically improve the portfolio returns.

For decades, a common practice by investors has been to use the PE ratio as the initial stock filtering criterion. A low PE ratio is a good investment and a high PE ratio means we eliminate the idea at the very outset. By doing this, investors run the risk of eliminating potential outstanding investment opportunities. Inclination towards a stock that is trading at a low PE often leads to poor investment outcomes. Almost every serious investor has "value trap" stories to share about apparently cheap stocks that seemed like bargains, only to tank lower in price.

There is no guarantee that a stock trading at 8 PE can't go down to 4 PE and there is also no rule that a high PE (perceived expensive) stock can't be a stellar performer in your portfolio. Thus, it's a grave mistake to overlook a business just because it is trading at an expensive PE ratio.

A stock can remain expensive or become more expensive on the PE ratio as long as it is backed by a business that's growing rapidly without compromising on cash flows and the quality of its balance sheet (in other words, it is generating high returns in its business). As Peter Lynch puts it, "people concentrate too much on the P (Price), but the E (Earnings) really makes the difference. Let us take a simple example to demonstrate what we are saying.

Page Industries stock was valued at a PE of 15x at the height of the Global Financial Crisis led bear market in 2009. More than a year later, the stock price leaped 4x and the PE ratio jumped to 40x. For many investors, such a premium PE ratio would have been a significant deterrent to an investment in the stock, but, the move for Page had just started.

The PE expansion in Page Industries continued unabated till 2015, when the stock's PE reached 85x. During this time, the stock went up another 12x. The earnings growth kept fueling the PE expansion for a long time. Investors who thought the stock was expensive at 40x PE, missed the grand rally that followed.

Our research suggests that a general averseness to buy high quality and growing companies at high multiples would have eliminated some of the largest wealth creators of the past. One would have missed Bajaj Finance, HDFC Bank, Jubilant Foodworks, DMART, Eicher Motors, Nestle, HUL, Relaxo, Astral Poly, Asian Paints, and many other price performers that traded at high PE multiples prior to their biggest price moves.

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Name of Company	Initial PE	Stock return and time period
Page Industries	40	1100% in 6 years
Eicher Motors	35	900% in 4 years
Relaxo Footwears	40	900% in 7 years
Bajaj Finance	60	10800% in 10 years
Jubilant Foodworks	58	1300% in 10 years
DMART	80	300% in 3 years
Ajanta Pharma	50	600% in 3 years
Britannia	80	1600% in 9 years
Nestle India	50	500% in 10 years

As we can see, what appeared like high PE stocks prior to their moves, ended up being bargains of a lifetime. Instead of focusing on the "high PE", many investors failed to focus on the size of the opportunity and the earnings growth potential.

A few rules that investors should follow when evaluating high PE Stocks:

1. **Leadership** - Study and understand the business' leadership potential, potential to scale, its strength, management pedigree and governance practices. Identify your business as a good and leading business first.

2. **Serious earnings growth potential** - check for substantially accelerating earnings over the years to come. Stock prices love earnings growth, which could keep pushing the high PE ratio even higher. Studies show that PEs for businesses that are seeing exceptional growth end up expanding up to 3x in bull markets, thus resulting in a windfall for an investor over time.

3. **Value the Business** - Check if the stock is expensive in the short-run but cheap in the long-run by determining the company's ability to multiply in size and command premium valuations. Establish margin of safety through assessment of longevity of growth and leadership.

In conclusion, for many investors, the price-to-earnings or the P/E ratio has been the holy grail of equity investing. But high PE ratios have also been a limiting factor for many investors. Using the PE ratio in the correct manor can open a window of opportunities and bolster portfolio returns for investors.

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