Student Guide

Class #14 Price-to-Earnings Ratio Quick Lesson & Financial Board Games

Investors need methods to evaluate whether companies might be reasonable investments

Price-to-Earnings Ratio (“PE Ratio”) is one way to measure the value of companies

PE Ratio = Stock Price Per Share / Earnings Per Share

By comparing the PE Ratio of a company to the PE Ratio of a broad stock index, investors can determine whether a company is “more expensive” or “less expensive” than the broad financial market

Rational investors expect greater growth of revenues and profits from companies that are more expensive than the broad financial market

Example and Exercises

ABC Company

Earnings = $1 Billion

Shares Outstanding = 1 billion

Calculate the Earnings Per Share.

Share Price = $20

Calculate the PE Ratio.

Holding other factors constant, calculate the PE Ratio if the share price increases to $30.

The following year, ABC Company’s earnings were $2 billion, and the share price was $28. Presuming the shares outstanding were constant, calculate ABC Company’s PE Ratio.

If the PE Ratio of the S&P 500 index is 20 and ABC Company has a PE of 14, what might investors infer?

Key takeaways

1. **Investors need methods to evaluate whether companies might be reasonable investments.**
2. **Price-to-Earnings Ratio (“PE Ratio”) is one way to measure the value of companies.**
3. **PE Ratio = Stock Price Per Share / Earnings Per Share**
4. **By comparing the PE Ratio of a company to the PE Ratio of a broad stock index, investors can determine whether a company is “more expensive” or “less expensive” than the broad financial market.**

5. **Rational investors expect greater growth of revenues and profits from companies that are more expensive than the broad financial market.**

Financial Board Games: Bulls & Bears, Cashflow, Monopoly