

## The Growth Multiplier: Price Earnings Multiples and Why PEG Ratios Matter

By Peter Hunt, Chief Investment Officer



*“I don’t chase value stocks — I have higher multiples standards.”*

### Growth: The Universal Language of Markets

Every era of investing rediscovers the same truth in new vocabulary: growth drives price. While dividends may soothe and buybacks may please, sustained earnings growth is what compounds wealth. A stock price may rise over time not necessarily because investors love a company’s history, but because they believe in its future.

Mathematically, every stock’s price is a function of two components, its earnings and its price / earnings multiple (P/E Multiple).

$$\text{Price} = (\text{Earnings}) \times (\text{Price/Earnings Multiple})$$

Earnings capture what a business produces today. The multiple captures what investors expect tomorrow. Growth connects the two.

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## The Two Engines of Stock Price Performance

Long-term equity returns have two fundamental drivers:

1. **Earnings Growth** - the fundamental engine that compounds intrinsic value.
2. **Valuation Expansion (or Contraction)** - the psychological engine that translates belief into price.

Various empirical studies suggest that roughly two-thirds of stock market returns over decades come from earnings growth. The remaining return comes from changes in the multiple — from how much investors are willing to pay for each dollar of earnings. Thus, valuation is not a static ratio; it's a moving gauge of growth expectations.

### The P/E Ratio: The Market's Gauge of Confidence

The Price/Earnings ratio or multiple is the one of the market indicators for how much it believes in a company's future earnings potential.

- A high P/E means investors expect rapid, durable growth and are willing to prepay for it.
- A low P/E means they expect limited or unstable growth and demand a discount for risk.

The P/E multiple doesn't cause stock appreciation; it translates confidence in future growth into present valuation. When earnings rise and the multiple expands, price performance accelerates exponentially. When earnings rise but the multiple shrinks, price stagnates - proof that perception can overrule arithmetic.

### Why Growth Commands a Valuation Premium

#### 1. Compounding Power

Earnings growth creates exponential value over time. A firm compounding earnings at 15% annually doubles profits every five years, making today's valuation cheap in hindsight.

#### 2. Scarcity Value

Sustained growth above economic averages is rare. Investors may be willing to pay a premium for companies that can outgrow GDP and inflation consistently.

#### 3. Risk Compression

Predictable growth lowers perceived uncertainty. As perceived risk declines, required return falls — and the P/E multiple may rise as a result.

## 4. Narrative Energy

Growth stories mobilize capital and imagination. Investors project innovation into the future; that optimism becomes part of the price.

### The PEG Ratio - Where Growth Meets Valuation

The PEG ratio (Price/Earnings-to-Growth) refines an investor’s understanding of P/E by dividing it by the company’s expected earnings growth rate:

$$\text{PEG} = (\text{P/E Ratio}) \div (\text{Annual EPS Growth Rate})$$

It answers a critical question: How much am I paying for each unit of growth? And, it provides the investor with a means to assess whether a company is over- or under-valued relative to its growth rate. By way of illustration:

- **PEG < 1.0** → Growth may be underpriced and a company may be under-valued.
- **PEG ≈ 1.0** → Growth may be fairly priced and a company is likely fairly valued.
- **PEG > 2.0** → Growth may be expensive and a company is likely over-valued.

Where the P/E shows what investors are paying, the PEG ratio shows whether the price is justified by growth potential.

### PEG in Practice: Interpreting Growth Value

Consider two companies:

Metric	Company A	Company B
P/E	20x	40x
Expected Growth	10%	30%
PEG	2.0	1.33

At first glance, Company B looks “expensive.” But adjusted for growth, it’s actually cheaper per unit of expected expansion. This explains why high-growth firms like Nvidia, Tesla, or Amazon can sustain elevated P/Es for years - the **G** in PEG rationalizes the **P**.<sup>1</sup>

The PEG ratio thus converts valuation into a growth-adjusted fairness test - a compass for investors balancing conviction with caution. The art and science of using a PEG ratio is when the PEG is in the gray area between 1.0 and 2.0. The science says the closer a PEG gets to 2.0 the higher the likelihood a stock

<sup>1</sup> References to specific companies are provided solely for illustrative purposes and do not constitute investment recommendations

is over-valued. However, comparing PEG ratios across a universe of comparable companies reveals the art of stock picking and where the magic happens. One man's over-valued stock is another man's under-valued opportunity.

## Correlation and Causation in Growth Valuation

A common analytical trap is mistaking correlation for causation. We often observe that “companies with high growth trade at high multiples.” That’s correlation. Causation flows differently: Sustainable earnings growth often leads to increased investor confidence which may lead to lower perceived risk which can result in a higher P/E multiple and thus a higher price.

In short: growth doesn’t automatically cause a higher multiple; belief in its durability does. The PEG ratio helps isolate that belief - measuring whether valuation is proportional to growth reality or inflated by narrative excess.

## The Lifecycle of Growth and Multiples

As companies mature, growth slows and P/E multiples compress - a natural gravitational law of valuation. The PEG ratio charts this evolution elegantly:

Corporate Stage	Typical Growth	Typical P/E	Typical PEG	Market Interpretation
Early Growth	20–40%	40–80x	~1.0	Reinvestment-driven optimism
Maturing Growth	10–20%	20–30x	1.0–1.5	Balanced growth and yield
Stable Cash Flow	3–8%	10–15x	>2.0	Cash-generation focus

When a company transitions from high-growth to moderate-growth, its PEG ratio usually rises—signaling that the multiple has not yet adjusted downward to slower expansion. Investors who ignore this transition risk holding overvalued “ex-growth” names.

## When PEG Breaks Down

The PEG ratio, while elegant, assumes linear growth and stable risk - conditions rarely true in dynamic markets.

### Limitations:

1. **Cyclical companies** show volatile earnings, distorting both numerator and denominator.
2. **Early-stage firms** with negative earnings or explosive near-term growth defy simple ratio logic.
3. **Quality of growth** (organic vs. leveraged) matters as much as quantity; PEG ignores that distinction.

Used properly, PEG is a contextual lens, not a verdict. It measures valuation proportionality, not destiny. It also provides a relative benchmarking tool for analyzing comparable companies in a targeted industry or sector.

## The Behavioral Layer - Perception as Multiplier

Markets don't only value growth, they value the credibility of growth. For example, a 15% growth rate with 90% confidence is typically worth more than 20% growth with 50% confidence. The P/E multiple captures that confidence premium.

PEG ratios below 1.0 can persist if investors doubt management's projections. Conversely, "story stocks" can sustain PEGs above 2.0 if the narrative temporarily overpowers skepticism. Thus, growth valuation is not purely numeric - it is behavioral, shaped by trust, communication, and the emotional discount rate investors apply to uncertainty.

## From Equations to Reflexivity

In the Post-Modern view of markets, growth and valuation are not separate, they are reflexive.

1. Growth drives higher valuation.
2. Higher valuation lowers cost of capital.
3. Lower cost of capital funds more growth.
4. Growth reinforces valuation.

This loop persists until the story breaks -when expectations exceed execution. The PEG ratio often is an indicator that the loop is overheating: a rising PEG without accelerating growth signals belief decoupling from reality.

## Historical Lessons

- **1990s Tech Boom:** PEG ratios of 4–6 signaled belief outrunning fundamentals; eventual correction restored proportionality.
- **2000s Energy & Financials:** Low PEGs masked cyclical earnings peaks - "cheap" stocks proved traps.
- **2010s–2021:** Secular growth in software and AI justified high P/Es, but only because growth persisted.
- **2022–2024:** Rate hikes compressed P/Es across the board; PEG ratios normalized as markets revalued long-duration growth risk.

Across decades, the pattern repeats: growth credibility defines the multiple; PEG quantifies that credibility.

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## Practical Takeaways

### For Investors

- Use P/E to gauge *market sentiment*; use PEG to gauge valuation fairness.
- A PEG below 1.0 isn't always a bargain, but it warrants investigation, along with other indicators.
- Track *changes* in PEG - rising PEG without rising growth often signals peak optimism.
- Focus on the quality and durability of growth, not just its rate.

## The Formula for Long-Term Value Creation

Ultimately, stock price performance rests on a simple truth: Total Return = Earnings Growth + Change in Multiple + Dividends (among other indicators as well).

Growth fuels earnings; credibility protects the multiple; dividends smooth volatility. The P/E reflects expectation, while the PEG tests proportionality between price and growth.

A company compounding earnings at 12% with a stable P/E of 20x doubles in six years. If confidence lifts the P/E to 25x, total return accelerates. If skepticism drives it to 15x, compounding slows despite operational success. Thus, managing perception - the "E" and the "G" in PEG - is as strategic as managing performance.

## Conclusion - The Art and Science of Growth and Valuation

Growth remains the primary engine of long-term stock appreciation. But valuation - the multiple investors attach to that growth - is the gearbox that transmits power.

The P/E ratio reflects belief; the PEG ratio tests belief's rationality. When the two align, investors may experience favorable outcomes; however all investments remain subject to risk. When they diverge, markets correct the imbalance with brutal efficiency, as results and the changing market impact price.

In a world of narratives, algorithms, and cycles, the investor's task remains the same: Find companies where growth is real, belief is proportional, and the PEG tells a story of balance - not illusion. The best investments are not those with the highest growth or the lowest P/E - but those where growth and valuation rhyme in harmony.

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