OPINION

Trailing or forward P/Es: Here’s which one has the better predictive power for picking winning stocks

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Value investors like to search out bargains by sorting stocks into quartiles according to their P/E ratios and then focus on the lowest P/E ratio group. They believe that the lowest P/E stocks, on average, outperform stocks with high trailing P/E ratios. Other investors, however, like to use forward P/E ratios to identify stocks they expect to outperform.

But which metric has a better predictive power as far as stock returns are concerned: trailing or forward P/E ratios? Do low P/E quartile stocks yield higher or lower returns vis à vis high P/E quartile stocks when P/E is defined based on trailing or forward earnings?

There is no doubt that low P/E stocks beat high P/E stocks. The evidence is overwhelming. Low P/E stocks outperform high P/E stocks by between 6 per cent and 13 per cent, depending on the country. This outperformance, on average, holds steady over different time periods, as well as during recoveries/recessions and bear/bull markets. Nevertheless, there is not much evidence as to which stocks do better – those that have low forward P/E or low trailing P/E.

Forward P/E ratios look relatively reasonable compared with historical averages these days, particularly for emerging markets and growth indexes and vis-à-vis trailing P/Es, which do not. Should we all then be running to buy Nasdaq-listed, or emerging market ETFs?

Not so fast. My research shows that for some markets, such as the NYSE, forward P/E ratios are a good indicator of future returns. They are, however, poor predictors of

future returns for other markets – such as Nasdaq – that are home to the riskier groups of stocks which also include emerging market ETFs.

I find that forward P/E stocks in the lowest quartile have the same returns as high forward P/E quartile stocks for AMEX-listed stocks (now known as NYSE American). However, they beat the high P/E quartile stocks by 2.4 per cent for Nasdaq and 11.64 per cent for NYSE stocks.

The evidence using trailing P/E ratios? Low trailing P/E quartile stocks beat the high P/E quartile stocks by 6.24 per cent for AMEX, 11.4 per cent for Nasdaq and 9 per cent for NYSE stocks.

Why do forward P/E ratios have inferior forecasting ability compared with trailing P/E ratios? The answer is simple. Trailing earnings are based on realized earnings, while forward earnings are based on forecasts by analysts. Analysts tend to be overoptimistic when forecasting earnings. This bias pushes down forward P/E ratios, giving the impression that a stock commands a low P/E when in fact that may not be the case. Earnings are eventually revised downward and what appeared at first to be a value stock may, in fact, turn out to be a high P/E stock.

For example, on average within a calendar year, analysts overestimate actual earnings by about 2.5 per cent. But the overestimation is about 8 per cent at the start of the forecasting period. Accuracy improves as analysts approach the end of the year which they are forecasting.

What is more interesting, however, is that analysts are not overoptimistic across all companies covered. They tend to be overoptimistic only for stocks around which there is high degree of uncertainty. For stocks with low uncertainty, analysts tend to be pretty accurate. In fact, I find that for stocks with the lowest uncertainty, analysts, on average, exhibit no upward earnings forecast bias within a calendar year.

But when it comes to the group of stocks with the highest uncertainty, on average, analysts tend to overestimate actual earnings by 21 per cent. These are big errors, hence the inaccuracy of forward P/E ratios, particularly for this group of stocks.

In other words, forward P/E ratios can be a good predictor of future returns for low-uncertainty stocks but are quite inaccurate for high-uncertainty stocks. This may explain why forward P/E ratios work well in predicting future returns for NYSE stocks, but they do not work as well (compared with trailing P/E ratios) for AMEX and Nasdaq stocks, namely, the riskier group of stocks.

As a result, if investors want to stop worrying about the uncertainty underlying a company's future, they should consistently use trailing P/E ratios to screen stocks. In fact, this is the approach that the father of value investing, Benjamin Graham, followed when he wanted to identify stocks that were likely to outperform. Investors should follow his lead, especially when it comes to riskier markets.

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