OPINION

Which P/E ratio measures markets better: trailing or forward? The answer is sure to spook investors right now

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A trader at the New York Stock Exchange in August. The U.S. market looks particularly overvalued based on trailing price-to-earnings ratios.

ANGELA WEISS/AFP/GETTY IMAGES

No matter how one looks at the price-to-earnings ratio, trailing or forward, the U.S. stock market seems to be overvalued right now. However, the market looks particularly overvalued if one focuses on the trailing P/E.

With a median historic P/E ratio of about 18 times corporate earnings, the trailing ratio of the S&P 500 Index is currently around 30 times; the forward P/E ratio at about 24 times seems moderate in comparison.

What should we believe in? Is the U.S. market severely overvalued or somewhat overvalued?

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There is no doubt that low (trailing or forward) P/E stocks beat high P/E stocks. The evidence in this regard is overwhelming.

But my research shows that trailing P/E ratios have superior forecasting ability compared to forward P/E ratios. The reason is simple. Trailing earnings are based on realized earnings, while forward earnings are based on earnings forecasted by analysts.

Analysts tend to be overoptimistic when forecasting earnings. This biases forward P/E ratios down, giving the impression that a stock commands a low P/E. In fact, it may not, as 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 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 for which there is high uncertainty about the future.

For stocks with low uncertainty, analysts tend to be pretty accurate. In fact, I find that for the lowest uncertainty stocks, analysts, on average, exhibit no upward earnings forecast bias within a calendar year.

But when it comes to the highest uncertainty group of stocks, 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 they are quite inaccurate for high uncertainty stocks. This may explain why I find that forward P/E ratios work well in predicting future returns for New York Stock Exchange stocks, but they do not work as well (compared to trailing P/E ratios) for Amex (now known as NYSE American) stocks and Nasdaq stocks – namely, the riskier group of stocks.

Using data from Compustat over the 20 years between 1986 and 2006, I find that the lowest forward P/E-based quartile stocks experience same returns as the highest forward P/E quartile stocks for Amex stocks and beat the highest P/E quartile stocks by only 2.4 per cent for Nasdaq.

The evidence using trailing P/E ratios is as follows. The lowest trailing P/E-based quartile stocks beat the highest P/E quartile stocks by 6.24 per cent for Amex, 11.4 per cent for Nasdaq.

Why growth stocks get too much attention

In general, similar results were found in a study produced by the CFA Institute and reported on its Enterprising Investor blog site. The author of the report, Joachim Klement, examined U.S. (S&P 500), British (FTSE 350), euro zone (Euro StoXX 300) and Japanese (Nikkei 225) stocks over the 20 years between 1994 and 2014. Using data from FactSet, he formed quintile portfolios based first on trailing P/E and then on forward P/E ratios, using Institutional Brokers' Estimates System consensus earnings forecasts.

In the United States, the cheapest quintile stocks based on trailing P/E ratios outperform the most expensive by 1.2 per cent per year. Based on forward P/E ratios, the cheapest stocks underperformed the most expensive by 1 per cent annually.

In Britain, the corresponding numbers were 10.1 per cent and 7.4 per cent per annum, respectively. While in the euro zone, they were 4.6 per cent and 3.5 per cent per annum, and for the Japanese stocks, 6.6 per cent and 0.6 per cent per annum, respectively.

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.

Bottom line: The U.S. market is severely overvalued.

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