MYTH: LOW P/E STOCKS OUTPERFORM HIGH P/E STOCKS

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Most academic studies conclude that the value investment style beats out the growth style in seeking high returns. However, there is a divide between academia and the real world as the vast majority of top performing funds over the past 40 years have been growth funds – not value funds. The principal distinction between the two investment styles centers on price-to-earnings ratios, comparatively high P/E's for growth and low P/E's for value.

In a survey of investors conducted by Merrill Lynch in 2019, 80% of managers responded that they consider forward price-to-earnings ratios, tilting towards low P/Es, as the number one reason for buying a stock. This means that the preponderance of managers shy away from high P/E stocks.

Other studies show that many top performing stocks start out with high P/E's. For example, Target QR conducted a study on the 10 best stocks during 2006-2015, with cumulative returns ranging between 845% - 5,345%, and found that they started out with an average P/E of 64x prior to their runs.

William O'Neil, publisher of Investor's Business Daily, studied top performing stocks over the period 1959-1982 and wrote in his book "according to our historical study on all the greatest winning stocks, if you'd been relying on P/E ratios, you would have missed almost every major winner for decades".

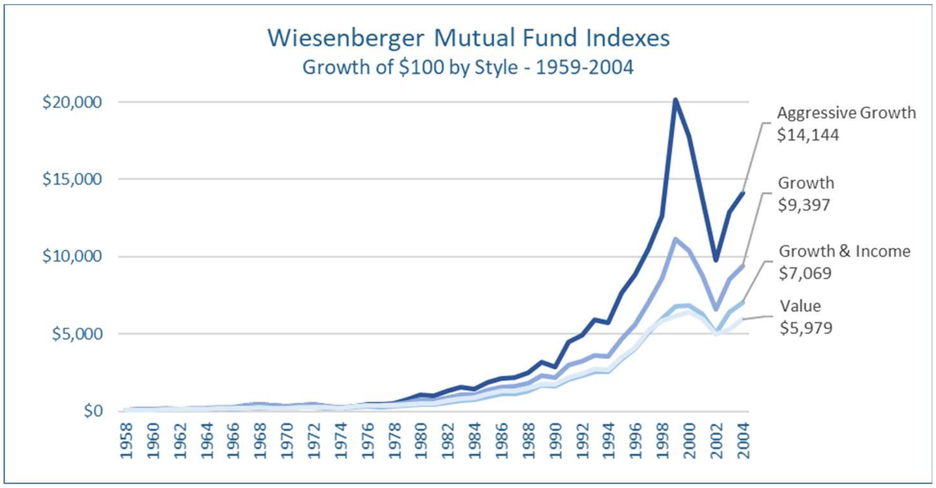
In another study by Investor Business Daily on 120 top performing stocks during 1996-1997, the top performers advanced 120% versus 64% for the S&P 500. The top stocks were selling at a much higher market at the outset.

Kidder Peabody, once a prominent brokerage firm, used to track monthly price movements of the so-called "Nifty Fifty" stocks starting in the 1970's. The Nifty Fifty, made up with the highest P/E stocks, produced a cumulative return of 388% compared to 284% for the S&P 500 during 1972-1994.

For years, Wiesenberger compiled data on different investment styles using its own indexes. Returns for each style are shown below.

Capital asset pricing theory has reared its head here as risk and reward are perfectly aligned. Note the sizable difference in dollars at the end between the growth and income (synonymous with value) styles. Also note that the highest risk style generated the highest return.

No doubt the debate over low and high P/E outcomes will continue to be waged by researchers and strategists in coming years. However, there is an abundance of empirical evidence that supports the case for high P/E stocks, or disregarding P/E's altogether when investing.



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