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A company's price-to-earnings ratio, or PE ratio, is a single number that packs a lot of punch, and one of the most common ways to value a company's stock shares. But what is it, and what makes it so important?PE ratio is a metric that compares a company's current stock price to its earnings per share, or EPS, which can be calculated based on historical data (for trailing PE) or forward-looking estimates (for forward PE). It's a standard part of stock research investors use to:Compare the stock prices of similar companies to find outliers.Determine if the stock is undervalued, appropriately priced or overvalued.Decide, based on its value, if they should buy, sell or hold any particular stock. "PE ratio" may sound technical, but it's really just a comparison of how the public feels about a company (its stock price) and how well the company is actually doing (its EPS). The reading (and its inferences) can also be applied to market indexes, such as the S&P 500, Dow Jones Industrial Average and Nasdaq.NerdWallet rating NerdWallet's ratings are determined by our editorial team. The scoring formula for online brokers and robo-advisors takes into account over 15 factors, including account fees and minimums, investment choices, customer support and mobile app capabilities.NerdWallet rating NerdWallet's ratings are determined by our editorial team. The scoring formula for online brokers and robo-advisors takes into account over 15 factors, including account fees and minimums, investment choices, customer support and mobile app capabilities.\$0per trade for online U.S. stocks and ETFs\$0.005per share; as low as \$0.0005 with volume discountsHere's one scenario: A company posts stable profits quarter after quarter, and its projected profits are equally stable. If its stock price jumps but its earnings stay the same (and no earnings increases are expected), the company's intrinsic value didn't change; the market's perception of the company did.In this instance, the earnings in the PE ratio stayed the same, while the price soared, which mathematically sends the overall PE ratio higher. If a company's PE ratio is significantly higher than its peers, there's a chance the stock is overvalued.Another way to understand PE ratio: It's a measure of how much investors are paying for every \$1 of a company's earnings. Imagine two similar companies in the same sector. One has a share price of \$100 and a PE ratio of 15. The other has a share price of \$50 and a PE ratio of 30. The first company's share price may be higher, but a PE ratio of 15 means you're only paying \$15 for every \$1 of the company's earnings. Investors in the company with a PE ratio of 30 are paying \$30 for \$1 of earnings.To arrive at a company's PE ratio, you'll need to first know its EPS, which is calculated by dividing the company's net profits by the number of shares of common stock it has outstanding. Once you have that, you can divide the company's current share price by its EPS.For example, if a company has earnings of \$10 billion and has 2 billion shares outstanding, its EPS is \$5. If its stock price is currently \$120, its PE ratio would be 120 divided by 5, which comes out to 24. One way to put it is that the stock is trading 24 times higher than the company's earnings, or 24x.Just because you know how to calculate PE ratio doesn't mean you have to. Online brokerages offer stock screening tools that tell you the PE ratio of a stock, along with many other helpful data points.There's no single "good" PE ratio because it's a comparison tool, not a benchmark figure.However, by comparing PE ratios, you can uncover a lot about a particular company. Below are a few examples of what certain PE ratios may tell you when compared to the ratios of other companies.To get a better understanding of this, explore the following tool, which looks at a hypothetical stock and how its price movements and changes in earnings affect PE ratio.A stock's PE ratio can rise if investors believe future earnings will be higher than current levels, which is typically how "growth stocks" are defined. According to Robert Johnson, a chartered financial analyst and CEO of Economic Index Associates in New York, higher PE ratios often go hand-in-hand with such growth stocks. "Typically, stocks selling at higher PE ratios have higher growth expectations than those selling at lower PE ratios," Johnson says. "In essence, investors are willing to pay a higher premium for current earnings because they expect future earnings to grow substantially."If a stock's PE ratio is significantly higher than those of other similar companies — or even than the company's own historical PE ratio — it could be due to growth prospects, but it's also possible the stock is overvalued."When overall market sentiment is positive, PE ratios can be very high, as investors place a high premium on future growth prospects. However, PE ratios can also be very high when overall earnings fall considerably," Johnson says, adding that the S&P 500's high PE ratio of the early 2000s was largely due to falling earnings.To understand this from a technical view, remember the formula. If earnings fall but the stock price remains the same, the PE ratio will rise, suggesting the company may not be as valuable as the stock price reflects.Differentiating between overvalued stocks and growth stocks comes down to further analysis. Is the high PE ratio a symptom of market-driven hype? Or is there a better reason investors are anticipating higher future returns? These are questions you could ask to decide if it might be time to buy, sell or hold.A low PE ratio may signal that the stock price doesn't accurately reflect the true value of the company based on its earnings.In this instance, the stock price may stay the same while the company's earnings increase, which would send the PE ratio lower. Investors may see this as an opportunity to buy the stock with the expectation that the price will rise in the future to reflect the underlying earnings increase, a strategy that aligns with value investing. "Value investors generally prefer firms selling at lower PE ratios, as they believe there is less chance they will be disappointed that future growth prospects will not be realized," says Johnson.There's also another way to read into low PE ratios. According to Johnson, that low reading could be well-deserved. "Just because a stock is selling at a relatively low PE ratio certainly does not mean that it is undervalued," he says. "It may sell at a low PE ratio because investors are pessimistic regarding future earnings from the stock."Discerning between undervalued stocks and potentially troublesome stocks also requires further analysis. Ask yourself questions similar to those listed above to differentiate between undervalued companies and companies that may have hit a lag in earnings.While PE ratio can be a good way for investors to evaluate companies, it has its drawbacks. Aaron Sherman, a certified financial planner and president of Odyssey Group Wealth Advisors in Lancaster, Pennsylvania, cautions investors against using PE ratio alone in making their investment decisions."In the last 20 years, for example, the S&P 500 has seen PE ratios as low as 13 and as high as 123. While that high number of 123 might make it seem like the market is extremely valued, that ratio happened in the spring of 2009 — the beginning of one of the longest bull runs in U.S. history — so an investor who sold based on the high PE ratio would have missed out on all of those gains," Sherman said in an email interview."Using the PE ratio to take advantage of perceived under- or over-valuations in the market would require that the ratio always reverts to some historical average. The reality is that the PE ratio is not a great basis for investment decisions because there is simply no magic number to which the ratio tends to revert."One of the most accepted maxims in the investing world goes for EPS data, too: Past performance doesn't guarantee future results.EPS is typically based on historical data, which can be an indicator of a company's future performance, but is by no means a guarantee. In some cases, a company's PE ratio could fluctuate based on one-time gains or losses that don't reflect sustained earnings. For businesses that are highly cyclical, a low PE ratio may signal an undervalued stock, when in reality, it's been operating in a period of high earnings that's about to end. An investor may buy in thinking they're buying at a discount, only for earnings to drop soon after — possibly followed by the stock price.Investors may also use what's called forward PE ratio in their analysis. Instead of using past earnings data to generate EPS, this ratio uses the company's own forward-looking guidance, which is the company's prediction of how it will perform in the future.While that's based on thorough research and analysis, at the end of the day, it's still a prediction. Moreover, companies that provide guidance in accordance with U.S. Securities and Exchange Commission law are protected from civil liability, shielding them from lawsuits filed by investors who bought stock based on forward-looking guidance that didn't prove true. In other words, when using forward PE ratio to justify a stock purchase, it's buyer beware.For many investors, low-cost index funds or exchange-traded funds are the easiest way to invest in stocks. Generally speaking, financial advisors often suggest that no more than 10% of your portfolio should be allocated toward individual stocks. If you do decide to build a portfolio out of individual stocks, make sure you do so after thorough research, including the PE ratio analysis outlined above.

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