

# Price to Earnings ratio of the S&P 500 well above historical average

by Howard Spieler

It is no secret that the S&P 500, measured by historical norms of price to earnings ratios, is still overpriced even after the carnage of the two year bear market. To measure the price to earnings ratio (P/E) of a stock, simply divide the price per share of the security by their yearly earnings (which can be measured a variety of ways; trailing 12 month earnings, actual reported earnings, or projected earnings). The higher the P/E, the more "expensive" the stock. The lower the P/E, the "cheaper" or "reasonably priced" a stock is. Investors are generally willing to pay a higher P/E for a growth company, based on greater potential future for earnings, while a high dividend, "old economy" stock will usually demand a lower P/E. If a company does not have earnings, like many internet stocks that were rising exponentially in the 90's, then a P/E is not possible to calculate.

This brief study looks at the historical average of the P/E ratio of the entire S&P 500 since 1926. The 25 year P/E average of the S&P 500 is 17.78, the 50 year average is 16.48. The level on June 30, 2002: 36.99.

That's 108% above the 25 year average and 124% above the 50 year average! In fact, to get back to historical levels, the S&P 500 would have to decline about 50% to 400 (or earnings would have to double while the S&P 500 price stayed relatively neutral). Of course, we are not predicting such a market disaster. We are merely illustrating how richly priced the market has become.

Look at the area of the chart highlighted by the dotted lines. From 1926 to about 1990 the P/E of the S&P 500 stayed in a range from about seven to 22. Starting in 1982, investors were beginning to pay much more for stocks than ever before. In fact, the P/E of the S&P 500 reached unprecedented levels continuously until the unheard-of level of 45 during the bubble of 2000. Even with an S&P decline of well over 40% from its all time highs, the current S&P P/E level of 37 is only 18% lower. Actual earnings have fallen by about 50%, in accordance with the market falling by roughly 40%. Yet the P/E ratio only declined from 45 to 37.

**Translation:** Even after such a big decline, investors are still paying much more for a company than they ever have in the past.

