

INVESTMENT STRATEGIES

Some investors make investment decisions purely on intuition or gut reaction. Others use a scientific approach – for example, using share **charts** or rules based on **ratios** or mathematical models. Neither will guarantee you success, so a mix of both is recommended for the Student Investor Challenge – it only costs a little more time! The more research you do, the more likely you will perform well because prices are based on **information** about markets and companies.

Certain ratios, like the **price-earnings (P/E) ratio**, are informative and can be used for stock selection. The P/E ratio is the ratio between the stock price and the earnings per share. While earnings per share is a ratio that will inform you about the profitability of the company, the price-earnings ratio informs you about how much you would pay for each unit of earnings. High P/E ratios suggest that investors are expecting earnings growth. What does a P/E ratio of 15.00 mean? Generally it means that investors are currently paying the equivalent of 15 years' worth of earnings to own a share of that company. If the P/E ratio is too high, it means either that investors are expecting profits to grow a lot, or that the stock is too expensive (that is, it will take too many years to recover the investment). However, it is important not to rely on one indicator alone but rather take into account several sources of information.

Activity 5.1

Calculate the P/E ratio for the companies below:

Company	Share price	Earnings per share	P/E ratio
Schroders	1,421.00p	54.00p	
WH Smith	431.80p	42.70p	
Next	2,037.00p	188.50p	

Source: www.londonstockexchange.com

Interpret the P/E ratio. Which company is expensive and why?

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Activity 5.2

A P/E ratio between 10 and 15 might be seen as acceptable by investors – but it's a subjective test. It's just another way of comparing the performance of one share against another. Now let's compare the P/E ratio of companies from the same sector. The relative P/E is the P/E of the company divided by the average P/E of the market.

Company	P/E ratio	Relative P/E
BT	10.37	0.864
Inmarsat	26.23	2.185
Vodafone	9.748	0.812
Sector average	12	1

Source: <http://uk.reuters.com>

Based on the above table, what company would you buy? If you had all the companies in your portfolio, would you sell any company? Why? What other information would you consider important to decide if a P/E ratio is high or low?

Activity 5.3

Based on the table below, which gives data for Sainsbury's (J) Plc (the supermarket chain), what can you say about the share price?

Year ending	EPS	P/E	Share price
24/3/2007	14.70p	37.40	
22/3/2008	19.60p	17.00	
21/3/2009	21.20p	14.80	
20/3/2010	23.90p	13.90	

Source: www.londonstockexchange.com

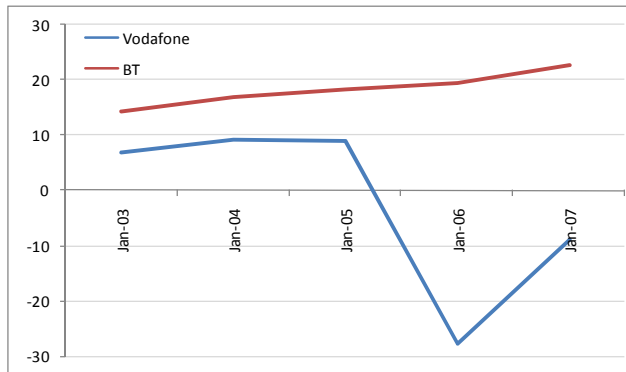
Tip Calculate the share price for each year and compare the changes in EPS, P/E ratios and share prices from 2007 to 2010.

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Activity 5.4

In the graph below you can see the evolution of the EPS of Vodafone and BT, two companies in the telecommunications sector.



What can you say about the companies? What can you say about the profitability of Vodafone?

Go to www.bloomberg.com, type 'VOD:LN' into the quote box. This will give you an up-to-date share price for Vodafone Group PLC on the London Stock Market. Check what the highest and lowest prices have been for these shares over the last year ('52-Week Range'). Then find the latest Price/Earnings ratio (on the same screen under the banner 'Earnings').

Would you buy a share of either of the two companies? Why?

Activity 5.5

Click on:

<http://uk.reuters.com>

Find the P/E ratio of HSBC Holdings Plc by entering 'HSBA.L' in the 'Search' box. Click on 'View Full Quote' then look at Financials on the right of the screen to find out what the P/E ratio is for this stock. How does it compare with the industry P/E ratio?

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Activity 5.6

A gilt is a bond issued by the UK government that promises to pay you a fixed interest rate. If the price of a gilt is £100, and the return is 4%, we can calculate the P/E ratio of a gilt to be 25 (that is, $100/0.04$). We know that gilts are risk-free securities and stocks are risky securities. Would you buy a stock with a higher P/E ratio than 25? Why?

Activity 5.7

Go to <http://www.thisismoney.co.uk/investing-tips-and-guides> and choose Share School lesson 2 – The financial pages for more information on price/earnings ratios and earnings per share.

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