

Making sense of sharemarket jargon

At times, sharemarket commentators and fund managers seem to speak a language of their own – constantly using terms such as P/E ratios and EPS. Whether you are a ‘DIY’ investor or whether you use a professional fund manager, it pays to have a basic understanding of share jargon and what it all means.

The above two terms are particularly relevant to sharemarket investment. EPS stands for ‘earnings per share’. It is calculated by dividing a company’s earning or profit (usually over a year) by the number of shares currently on issue.

The higher the EPS, the better – since it means the company is generating a higher profit for every dollar invested in its shares. For example, suppose the XYZ company has 50 million shares on issue and reported a \$10 million profit for the last financial year. Dividing 10 million by 50 million gives an EPS of 0.2.

The P/E ratio stands for ‘price-to-earnings ratio’ and is simply the relationship between a company’s share price and its earnings, or rather how expensive a company’s shares are. The ratio is calculated by dividing the latest earnings of a share (EPS) into the current share price. So if XYZ’s shares are trading at \$2.50, the P/E would be 12.5 (2.50 divided by 0.2). This means XYZ’s share price is currently 12.5 times its earnings per share.

There is no ideal P/E ratio; it’s all relative. For example, Telecom shares currently trade at around \$4.80, which represents a P/E ratio of approximately 13.3. Meanwhile, Guinness Peat Group is trading at around \$2.00 with P/E of 6.3, meaning they are less than half as expensive as Telecom, while The Warehouse, trading at around \$7.45 with a P/E of 34, is 2.5 times as expensive as Telecom.

However, it is actually more meaningful to compare the P/Es of two companies operating in the same sector – for example, Lion Nathan (16.4) and Dominion Breweries (12.9).

So far so good, but while P/E ratios are useful starting points, they also have their limitations. Because they are based on a company’s past earnings, they are backward-looking measures – and past performance is never a guarantee of future performance.

So, when deciding whether to opt for a DIY approach or use a fund manager, you should ask yourself on what basis you would pick your shares and how well you think your expertise stacks up against that of the professionals.

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