

P/E and PEG Ratios: How to Tell If a Stock Is Actually Expensive

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LEVEL	TOPIC	READ TIME	SERIES
Beginner	Equities	~5 minutes	Investor Education

“That stock looks expensive” is one of the most common phrases in investing - and one of the least useful, on its own. A \$500 share price isn't inherently more expensive than a \$50 one; what matters is how much you're paying relative to what the company actually earns. That's what the price-to-earnings ratio measures, and its close cousin, the PEG ratio, refines it further. Both show up constantly in our sector and CIO commentary, so here's what they actually mean.

What Is a P/E Ratio?

The price-to-earnings (P/E) ratio divides a company's share price by its earnings per share (EPS) - or, at the index level, a sector's or market's total price by its total earnings. A P/E of 20 means investors are paying \$20 for every \$1 of annual earnings the company generates. It's a shorthand for how many years of current earnings it would take to “pay back” the stock's price, all else being equal, and it's the most widely used starting point for judging whether a stock or sector is cheap or expensive relative to its own history or to the broader market.

A “forward” P/E uses analysts' estimated earnings for the next 12 months rather than the trailing 12 months already reported; you'll see both used, and it's worth checking which one a given figure refers to, since expected earnings growth can make the two numbers quite different.

Why P/E Alone Can Mislead

The problem with comparing P/E ratios in isolation is that it ignores growth. A company growing earnings at 30% per year arguably deserves a higher P/E than one growing at 3% per year, because a dollar of today's earnings is worth more if it's likely to become many more dollars of earnings in a few years. Comparing two companies' P/E ratios without accounting for their different growth rates is a bit like comparing two job offers by salary alone, without asking about the raises.

Enter the PEG Ratio

The PEG ratio solves this by dividing the P/E ratio by the company's expected earnings growth rate, expressed as a percentage. A stock trading at a P/E of 30 with 30% expected annual earnings growth has a PEG ratio of 1.0 — a widely used (though rough) rule of thumb for “fairly valued relative to growth.” A PEG above 1 can suggest a stock is pricing in more growth than analysts currently expect; a PEG below 1 can suggest the market is undervaluing the company's growth prospects, though it can also mean the market is skeptical those growth estimates will actually be met.

	P/E Ratio	Expected Growth	PEG Ratio	Rough Read
Company A	30x	30%	1.0	Priced roughly in line with growth
Company B	60x	15%	4.0	Priced well above its growth rate
Company C	15x	20%	0.75	Priced below its growth rate

Illustrative example for educational purposes. PEG ratio = P/E ÷ expected annual earnings growth rate (%).

This is exactly the kind of comparison that shows up in our own sector research: when we've noted that a sector's PEG ratios sit in a 1x-to-3x range today versus 4x-to-8x at the peak of the dotcom bubble, we're using this same tool to argue that today's higher headline P/E multiples are, in part, justified by higher underlying growth — not simply a repeat of past excess.

The Limits of Both Ratios

Neither ratio is a complete answer on its own. P/E and PEG say nothing about a company's debt levels, the quality or durability of its earnings, or whether analysts' growth estimates will actually materialize - estimates can be wrong, sometimes badly. They're best used as a starting point for comparison - a given company or sector versus its own history, or versus close peers with similar business models - rather than as a standalone verdict on whether something is a good investment.

KEY TAKEAWAYS

P/E ratio = share price ÷ earnings per share; it tells you how much you're paying for each dollar of current or expected annual earnings.

A higher P/E isn't automatically “expensive” if the company's earnings are growing quickly enough to justify it.

PEG ratio = P/E ÷ expected earnings growth rate; a PEG near 1.0 is a rough (not definitive) signal of fair value relative to growth.

Both ratios are best used as comparison tools - against a company's own history or close peers — not as standalone buy or sell signals.

Related Terms

- **Earnings Per Share (EPS):** Profit divided by the number of outstanding shares; the “E” in P/E.
- **Forward P/E:** A P/E calculated using analysts' projected earnings for the next 12 months, rather than earnings already reported.
- **Trailing P/E:** A P/E calculated using the most recently reported 12 months of actual earnings.

Where to Go From Here

P/E and PEG ratios are the most common starting point for valuation discussions, but they're just that — a starting point. If you'd like to see these tools applied to a live sector debate, our Research Article “Pricing the AI Supercycle” walks through exactly this kind of valuation analysis for the technology sector in detail.

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