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Trader's Notebook | Do P/E Ratios Really Matter?

12–15 minutes

In a Stocks & Commodities interview in April 1994, investor James B. Stack commented that market valuations, including price/earnings ratios, were at their highest point in history. He used this metric, together with a number of sentiment indicators, to opine that the correction taking place in the market was probably going to turn into a bear market. The Standard & Poor's 500 P/E was in the process of surpassing its previous high of 24, which was set back in 1966 — just before the beginning of a bear market that was to last until 1982. At the time of the interview, the Dow Jones Industrial Average (DJIA) was trading in the area of 3600. As we know now, that was just a pause. The ratio continued to rise, running into the mid-40s and taking the DJIA more than 300% higher to nearly 12,000 before the bears finally came out of hibernation en masse in 2001.

Stack is not the first analyst in history to take miscues from absolute valuations. As P/Es continued to hit new highs between 1995 and 2000, more than one analyst declared that the ratio was no longer relevant thanks to the birth of the new economy. Investors were repeatedly told to ignore valuations and invest for the long term. This turned out to be dubious advice at best for those who bought near the top in 2000 and