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## 96/02-Mind Your P's and E's

**A quick lesson in wiggle reading: The use of standard price and earnings charts to spot good buys (and bad) in growth stocks.**

**By Peter Lynch**

On my watch at the helm of the Magellan Fund, I often consulted a chart book to check the bearings of companies in the portfolio. Many investors focus on recent price, but I like to refer to certain 10-year and 35-year charts of earnings and price to give me a clue as to a stock's future value. The charts I use are republished by Securities Research Corporation. A subscription is expensive, but many libraries carry the latest copies, so they're easy enough to find.

Perhaps you follow the progress of companies with the price-to-earnings ratio, or p/e. A chart will tell you more: It tells the story of the ongoing relationship between the P and the E. It's like a tacking duel in a sailing race. As the earnings line (the E) gains or loses ground, the price line (the P) zigs and zags above and below it. E is the reality of a company's performance, while P is led around by Wall Street expectations. Each chart reveals something important about the way investors perceive a company.

The chart of the Standard & Poor's 500 Index (shown on the next page), which tracks earnings and stock prices of 500 large companies lumped together, lifts the fog from the market at large. We see the E tailing off in the recession of 1990 and 1991, while the P was on the rise. The P was ignoring the drop in the E because investors anticipated the economic recovery that began in early 1992.

To catch up to the rising P, the E basically had to double from 1991 to 1994, which it nearly did, taking Wall Street by surprise. In 1994 alone, the E was up 40 percent while the P went nowhere. Then in 1995, the E was up another 20 percent, for a combined gain of 65 percent in two years. This phenomenal rise in earnings is why the P in stocks had such a run in 1995.

This sort of chart reading works best with growth companies, ten of which also appear on the next page. I've also thrown in a cyclical, General Motors, for variety's sake. You can tell a growth company because the E keeps on a steady course, with earnings higher each year. Once you've identified a growth company from the E line, you follow the P line to get a read on whether the stock is expensive or cheap, relative to its earnings.

Overpriced growth stocks are doubly risky: If the earnings take a dive, the stock price heads for the bottom, and even if the earnings go up, the stock price may take a dive, or at best treadwater. When you way overpay for growth, the risk/reward ratio is highly unfavorable. The charts can help identify those situations.

Here are the charts of 11 companies (in no particular order) and the stories they tell:

Abbott Labs is a typical growth company, with the E on the rise and the P maneuvering around it. Every few years, as in 1987 and 1991, investors get carried away with Abbott's prospects and bid up the P, which puts a lot of distance between it and the E. The best time to buy the stock is when the P comes back to the E, or drops below the E, as it did briefly in 1993. When the two lines converge, it means the company's growth rate is equal to its p/e ratio—a good opportunity to invest in future growth at a bargain price. Today, we see the P drifting away from the E; Abbott is no longer the bargain it was two years ago, despite very good profits.

Walgreen is an excellent drug chain whose P rides above the E most of the time. This shows that investors are so confident of Walgreen's knack for making money, they're willing to pay a high price for future earnings growth.

The P drifted sideways in 1993 and '94. People who look only at stock prices might have thought something was wrong with the company. But the E kept rising, so people who paid attention to earnings knew the company was doing fine. The price simply got too high, as it does from time to time. It's moving in that direction again.

McDonald's is in the news; Warren Buffett is reportedly buying shares. No doubt he's aware of the risk: The gap between McDonald's P and its E hasn't been this wide since 1987, just before the October crash. Investors are counting on McDonald's to speed up its earnings by sending more and more Golden Arches abroad. If McDonald's doesn't accelerate the E, there's potential trouble ahead for the P.

Johnson & Johnson was one of my recommendations at the Barron's roundtable in January of 1994. I'd noticed the P had taken a rare dip below the E, which, as usual, was on a profitable tack. You can see what's happened since—the P reversed field and has shot from under \$40 to over \$90. Johnson & Johnson is still a great growth company with strong future prospects (I own it), but a wide gap has opened up between the lines.

Wal-Mart investors have had an unshakable faith in the rapid advance of the E, so until recently they paid a big premium for the P. Hence, there's been a gap you could drive a fleet through. By 1992, the P had strayed further from the E than at any time in the company's history. For three years thereafter, the earnings rose by nearly 50 percent and the stock went nowhere. Imagine the stock's fate if the earnings had dropped.

Recently, Wal-Mart's p/e gap has narrowed, making it less risky than it was in 1992. This hulking giant can't be expected to keep up the fast growth it enjoyed in years past, but the stock is priced for slower growth. The current p/e ratio on expected 1996 earnings is about equal to that of the average stock. If Wal-Mart's new supercenter stores are successful, it has a decent shot at a decade of respectable growth.

General Electric investors have always lacked faith in GE's ability to speed up the growth rate, so the P travels close to the E and often drifts below it. This chart is telling us: "GE can't keep up with a Wal-Mart or a McDonald's." Nevertheless, GE makes steady progress, and the E has always been on the rise. Saddam Hussein gave us a buying opportunity a few years back when the P veered sharply south in the months before Desert Storm.

Emerson Electric, a leading producer of electric motors and other industrial products, has sailed through recessions without a hitch: 38 consecutive years of rising E. You can see the point where Wall Street finally recognized Emerson as a reliable fast grower. In 1991, the P crossed above the E, and it's stayed there ever since.

As of this writing, Emerson sells for about \$80 a share, but if the market had continued to perceive it as an unreliable slow grower, the stock might well be selling for \$55 a share, a \$25 difference on the same earnings. Instead of being an \$18 billion company, Emerson would be a \$12 billion company. That's how much faith in future growth can affect a shareholder's pocketbook.

Coca-Cola's chart from 1984 to 1989 looked like it belonged to General Electric, and from 1988 forward, it looked like Wal-Mart's. The flagship of the soft-drink business suddenly was put on the fast track, and Wall Street noticed. While the E accelerated, the P raced ahead of it, creating a dangerous gap. At the start of 1992, any chart reader could see the P was out of line and the E needed time to catch up to it. The P went nowhere for two and a half years, while the earnings continued apace. Lately, the P has jumped again, and the gap has widened. Investors are betting once more that Coke will speed up the E.

Who knows how high the stock price will go? Maybe it will hit \$100 or \$120 a share and go from overpriced to grossly overpriced. Such an advance won't do long-term investors any good. Sooner or later, the P will come back to more sensible levels, because with Coke in more than 195 countries already, how can its E growth accelerate fast enough to support the rising P?

Automatic Data Processing is an even more consistent grower than Coke's 34 years of double-digit earnings growth every quarter, and all it basically does is handle other companies' payrolls. You had a great chance to buy it in 1989 and again in 1990, when the P and the E converged, but since that time, optimistic investors have bid up the P and widened the gap.

Philip Morris is another fast grower that Wall Street gives no respect. It's a chronically underpriced growth stock whose P stays well below the E most of the time. Investors continuously worry that Philip Morris will lose billions in lawsuits brought by smokers. Yet in spite of its underachieving P, the stock is up tenfold in ten years, thanks to the spectacular rise in the E. If Philip Morris maintains its earnings growth, investors will make money no matter what Wall Street thinks. Without the threat of lawsuits, the stock would be worth \$120 on earnings strength, as opposed to the \$90 it fetches today.

Now, General Motors. Can you see why this chart doesn't fit with the others? The E wobbles all over. It's the typical course of a cyclical company, as unpredictable as a hurricane's path. From 1984 to 1989, GM's E was far above its P, yet the P never rose to meet it because investors didn't believe the prosperity would continue. They were right: From 1990 to 1992, the E fell off the chart. GM was losing billions. Today, the E has moved back to the top of the chart, but judging by the sluggish P, investors are doubting it will stay put. GM has cut costs and revamped its operations. There's a chance the E will continue to advance and GM will ride out the next recession in the black. If that happens, investors will probably value earnings more highly in a subsequent recovery. It's a stock I own.

After saying so much about charts, I must issue the following disclaimer: I'm not a technical analyst, or a wiggle reader who makes predictions on the direction of the next wiggle. I use charts to help me find value among growth companies I follow.

I'd be the last person to suggest using these charts to sell your growth companies every time they looked way overpriced. Instead of investing for the long term, you become a market timer. But if you've got an extra pile of money to invest, and you see that your favorite growth company's P has far outdistanced its E, you might want to hold off on buying the stock until it becomes more reasonable. "Buy on strength," advisers may tell you—but the charts show it's a lousy strategy.

Do-it-yourselfers can plot their own charts with the help of the National Association of Investors Corporation, an umbrella organization for more than 18,000 investment clubs. They even have the graph paper with properly aligned price and earnings scales. For details, call 810- 583-NAIC.

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