



THE MOTLEY FOOL®

To Educate, Amuse & Enrich

Fool's School

P/E Ratios Explained



The price-to-earnings (P/E) ratio is a measure that compares a company's stock price to its earnings per share (EPS), usually for the previous 12 months. Think of it as a fraction, with the stock price on top and the EPS on the bottom. You can tap the stock's price into your calculator, divide by EPS, and voila — the P/E. The ratio is calculated for you at many online stock research sites, such as <http://finance.yahoo.com>.

Consider Gas Prices Inc. (ticker: ARM-LEG), trading at \$40 per share. If its EPS for the last year (adding up the last four quarters reported) is \$2, just divide \$40 by \$2 and you'll get a P/E ratio of 20. Note that if the EPS rises and the stock price stays steady, the P/E will fall — and vice versa. For example, a stock price of \$40 and an EPS of \$4 will yield a P/E of 10. (Savvy stock types might say that such a stock is "trading at a multiple of 10.")

You can calculate P/E ratios based on EPS for last year, this year or future years. Published P/E ratios generally reflect past performance. Intelligent investors should

really focus on future prospects by calculating forward-looking P/E ratios. Simply divide the current stock price by the coming years' expected EPS.

Many investors seek stocks with low P/E ratios, as they can indicate beaten-down companies that may rebound. But a low-P/E stock can always fall further. Low P/Es can be attractive, but remember that P/Es vary by industry. Car manufacturers and banks typically sport low P/Es (often in the single digits), while software and Internet-related companies command higher ones (often north of 30).

The P/E can give you a clue as to whether a stock is undervalued or overvalued, when you compare a stock's current P/E to its historic range. But don't stop your research there. There are many other numbers to examine when studying a stock — such as its sales and earnings growth rates, debt level and profit margins. Compare companies to their competitors, too. ■

My Dumbest Investment

Not the Next Google?

A few years ago I was thinking about how nice Google would have looked in my portfolio when Baidu.com, a major Chinese search engine, announced its planned initial public offering (IPO). I thought there couldn't be anything better — the up-and-coming China market combined with its own version of Google. Well, by the time my order went through, the price per share was over \$150, and when it fell, it fell hard to less than \$100. Needless to say, I lost a good amount because I forgot the first rule: If it's too good to be true and you have to act now, walk away and find something better.



— N.H., online

The Fool Responds: Baidu.com would still have been good to you, had you hung on. It was recently trading around \$250 per share, after surpassing \$400 earlier in the year. Still, it's smart to be wary of IPOs, as they're often for companies without strong, established track records, and their prices can be especially volatile. ■



Do you have an embarrassing lesson learned the hard way? Boil it down to 100 words (or less) and send it to *The Motley Fool* c/o *My Dumbest Investment*. Got one that worked? Submit to *My Smartest Investment*. If we print yours, you'll win a Fool's cap!

Last week's trivia answer

I trace my roots to 1976, when Price Club began selling just to businesses. Today I'm a no-frills retailer for members only, selling everything from wine to socks, books, luggage, tires, candy, coffins and cans of creamed corn. Based in the state of Washington, I operate more than 500 locations worldwide, employing 137,000 people. My average store size is 141,000 square feet. I sport more than 50 million card-carrying members and more than 27 million households. I raked in \$64 billion in fiscal 2007. My stock has more than doubled in the past five years. Who am I? ■

(Answer: Costco)



Write to Us! Send questions for *Ask the Fool*, *Dumbest* (or *Smartest*) *Investments* (up to 100 words), and your *Trivia* entries to Fool@fool.com or via regular mail c/o this newspaper, attn: *The Motley Fool*. Sorry, we can't provide individual financial advice.

What Is This Thing Called The Motley Fool?

Remember Shakespeare?
Remember "As You Like It"?
In Elizabethan days, Fools were the only people who could get away with telling the truth to the King or Queen.
The Motley Fool tells the truth about investing, and hopes you'll laugh all the way to the bank.

Ask the Fool

The Derivative Scoop

Q What are derivatives?
— Z.S., Salisbury, Md.

A "Derivatives" include options, futures contracts, warrants and more. Some are very creative financial instruments based on other instruments. While shares of stock represent real ownership stakes in real companies, derivatives often represent contracts, not assets. They derive their value from the performance of other assets, such as stocks, bonds or commodities.

Derivatives permit sophisticated investors to hedge their bets, engage in arbitrage (profiting from differences in prices), lock in prices and use leverage. For example, several derivatives may be based on a single bundle of home mortgages, with one representing the interest payments and another representing principal payments. Since they would react differently to interest rate changes, they will each likely appeal to a different kind of investor.

Derivatives are typically used by large, institutional investors to boost their overall return or to hedge against risk in their portfolios. They can be very risky, though, and when used aggressively can result in investors losing more than their initial investment. Even some Nobel Prize winners have lost big money on derivatives.

Q How do I determine my cost basis in a stock and my gain when I sell it?
— L.K., St. Joseph, Mo.

A Imagine that you buy 100 shares of International Alphabet Corp. (ticker: ABCDE) for \$30 each, paying a \$15 commission. Your cost basis is the purchase price (\$3,000) plus the commission, or \$3,015. The basis per share is \$3,015 divided by 100, or \$30.15. If you eventually sell the shares for \$40 each, or \$4,000, subtract the \$15 commission and your proceeds will be \$3,985, or \$39.85 per share. Your taxable capital gain will be \$970, or \$9.70 per share.

Got a question for the Fool? Send it in — see Write to Us. ■

Name That Company

I was formed in 2005, when Viacom split in two.

I'm an international mass media company, operating in television, radio, publishing and outdoor advertising. I own a major television network and 29 stations, along with Showtime Networks, CSTV: College Sports Television and half of The CW. I own 140 radio stations in 31 U.S. markets, and the Simon & Schuster, Pocket Books, Scribner and Free Press imprints. My King World



Productions unit is a top television syndicator, distributing "Wheel of Fortune," "The Oprah Winfrey Show," "Dr. Phil," "Inside Edition," "Jeopardy!" and soon Rachael Ray's talk show.

Know the answer? Send it to us with *Foolish Trivia* on the top and you'll be entered into a drawing for a nifty prize! ■

The Motley Fool Take

Wal-Mart's Strength

Wal-Mart (NYSE: WMT) continues to show considerable strength, despite signs of a worsening economy — or perhaps because of them. The discount giant's fourth-quarter net income increased 4 percent to \$4 billion, while revenues increased 8 percent to \$106 billion. International sales saw a whopping 19 percent gain.

Wal-Mart isn't downplaying the grim economic environment right now, although it does intend to capitalize on its price-cutting competitive advantage. In the company's statement, President and CEO Lee Scott said the economy remains "a critical factor" this year, and he acknowledged that consumers were watching their wallets in January. He also said

that Wal-Mart plans to "continue to strengthen our price leadership around the world."

Times are tough for many consumers — even higher-income shoppers who might have boosted their spending with home equity loans — and Wal-Mart's certainly known for rock-bottom low prices. Of course, this type of environment favors low-cost rivals such as Target, too.

In the long run, Wal-Mart still has work to do. However, the company appears to be willing to evolve, given a changing consumer landscape. For right now, though, it's arguably most at home in a penny-pinching economic climate. After several years of economic largesse and consumer excess, the discount giant seems to be back in its element. ■



BUSINESS BRIEFS

Reforming Florida's tax system subject of meeting

Property Appraiser Ken Wilkinson guest speaker



Wilkinson

Initiatives to reform Florida's tax system and establish limitations on government spending will be presented at the Real Estate Investment Society April 8 luncheon meeting. Lee County Property Appraiser Ken

Wilkinson, a member of the state Taxation and Budget Reform Commission, will be the featured speaker.

Wilkinson will provide an overview of Florida's tax system and the rationales for the various reform proposals now being considered by the state legislature. He has served as Lee County Property Appraiser since 1980. In 1992 he led the effort to establish "Save Our Homes," which provides a 3 percent cap on assessment increases on homesteaded property. In the late nineties,

Wilkinson successfully led the "Enough is Enough State Spending Limitation Initiative" to curb government spending. Over the past few years, as president of Save Our Homes / Portability, Inc., he has advocated portability for the Save Our Homes cap, which was approved by the legislature and Florida voters and becomes effective this year.

Wilkinson is also expected to provide an update on mapping, aerial photography, and real estate data services available through the Property Appraiser's office and Web site.

Under Wilkinson's guidance, the office has been a leader in making property information accessible to the public. Following the presentation, Wilkinson will address questions of specific interest to the real estate investment and development industry.

The meeting is sponsored by McGarvey Development, Inc., and will begin promptly at 11:45 a.m. on Tuesday, April 8 in the Magnolia Room at Pelican Preserve's Town Center, on Colonial Boulevard, one mile east of I-75 exit 136 in Fort Myers. Admission is \$25 for members and \$35 for guests, which includes lunch. Reservations are required by April 3 and may be made by calling Sharon Heston, (239) 410-1253, or visiting the REIS web site: www.reis-swfl.org. ■