**Checking Valuation With the PEG Ratio**

The Price-Earnings Ratio is the most widely used valuation ratio which is compared to the historical P/E ratio. This number may vary depending on how it is calculated: using trailing earnings, forward earning or a combination (two past and two future).

The PEG Ratio divides the P/E by a growth rate which can be averages from **historical** or **projected** growth rates.

Another complication is whether to include a adjustment for dividends in the growth. There are large and highly profitable companies that return much of their earnings to shareholders in the form of cash dividends. They may be growing slowly and appear to be significantly overvalued. The PEG doesn't take them into account. To include the dividend (then known as a PEGY ratio) an adjustment can be made as follows:

Dividend yield added to projected EPS growth rate, using this number to divide into the projected P/E.

The online tools don't have this measurement but it can easily be calculated using projected P/E and projected growth. This is what is used in Toolkit 6.

Making sense of the PEG ratio is more difficult than calculating it. Companies with high levels of growth helps to determine if the high P/E is warranted. It should be compared with the industry average.

Also note that interest rates affect PEGs. When rates are low, investors generally favor stocks compared with bonds, which raises P/Es. Interest rates also can affect the growth rates of companies.

A company with a PEG ratio under 1.0 might be considered undervalued, while a company with a PEG over l.5 might be considered overvalued. Some, however, will go up to 2.0 for a PEG. In an article in the Better Investing Magazine, Ralph Seger said he likes companies with a PEG of up to 1.1. Peter Lynch uses the following table:

|  |  |
| --- | --- |
| PEG | Evaluation |
| > 2.0 | Expensive |
| 1.5 | Consider Selling |
| 1.0 | Fairly Valued |
| 0.5 | Attractive |

Numbers like this tend to be much too simplistic. Mark Robertson has an excellent webinar on the PEG that can be accessed on the Better Investing web site. Go to research/ Better Investing Magazine and search PEG. I found 25 articles/webcasts to read/listen to.