

Looking for value



One of the most common measures of value suggests the UK stock market could deliver attractive returns to investors over the next 10 years.

A company's share price reflects many factors. They include the strength of its overall business and ability to continue generating profits well into the future, as well as the outlook for the industry sector in which the company sits and the wider economy in general.

When investing in the stock market, there are various measures we can use to assess whether today's share price represents good value for money. One of the most common is the price/earnings (p/e) ratio.

The p/e ratio is simply a company's share price divided by its earnings per share for a designated period, such as the past 12 months. In other words, the number conveys how much investors are willing to pay per share for £1 of earnings.

Poised for strong returns

It's one of the measures used by Franklin Templeton when selecting companies to include in the Omnis UK All Companies Fund. The managers running the fund know that in the past, p/e ratios have provided a reliable indication of future share price performance.

Figure 1 is based on the investable listed UK equity market. This is representative of the FTSE All Share Index, which is the investment universe for the Omnis UK All Companies Fund. The horizontal axis shows the average p/e ratio and the vertical axis displays annual total real returns (which account for the impact of inflation) over the next 10 years.

If you look at the top left corner of the chart, you can see the market's average p/e in 1974 was around 4 times and average annual returns over the next 10 years were just under 17%. In contrast, the market's average p/e in 1999 (just before the dotcom crash) was over 28 times, and returns over the next 10 years were negligible.

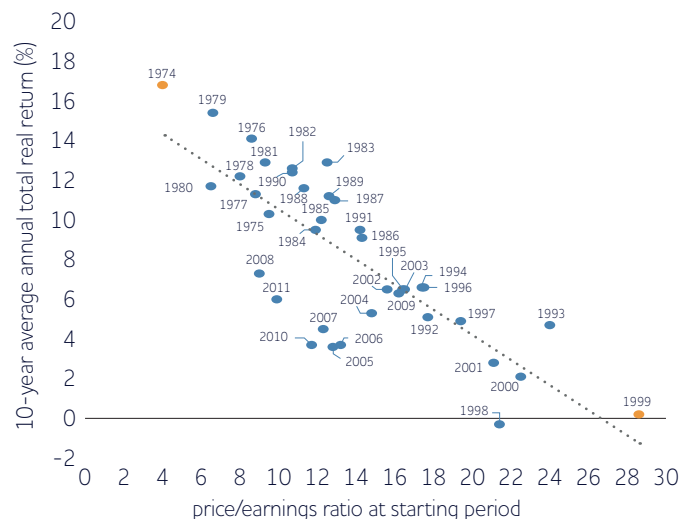
Stay invested

Today's average p/e ratio for the FTSE All Share is just under 9 times, which compares with an average of 15 times over the past 10 years. This difference represents a sizeable discount and suggests there's a good probability of decent returns over the next 10 years.

As we've often said, investing requires the patience and commitment to remain focused on your long-term objectives – even when the going gets tough as it has this year. While it might be tempting to sell some or all of your investments after such a challenging run throughout most of 2022, market valuations look attractive right now and you'll risk missing out on the recovery.

Figure 1: UK equity valuations and long-term returns

Stock market returns have been their highest over the next 10 years when p/e ratios are low.



Source: Lazarus Economics, 30 September 2022.

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