

Analysts also talk about 'quality of earnings' as well as the absolute number as being important (how sustainable are the profits? What activities are they derived from?). This is a question which needs further consideration in the light of accounting and other devices which are discussed later. The key question is the extent to which current profits are affected by special circumstances (e.g. asset sales) and to what extent they can be expected to continue for the foreseeable future.

The EPS number is used as an input to a market ratio, the *price/earnings* or *P/E ratio*:

$$\text{Price/Earnings} = \frac{\text{Market price per share}}{\text{EPS}}$$

The P/E ratio involves an amount not directly controlled by the company: the current market price of an ordinary share. It reflects how the market judges the company's performance. The P/E ratio is another form of rate of return ratio, albeit inverted. The numerator is today's market price and the denominator the EPS for the most recent 12 months. Thus, the P/E ratio varies throughout the year and the major financial newspapers usually display a company's P/E ratio along with the daily market prices of its ordinary shares.

The P/E ratio is also called the *earnings multiple*. It reflects the market's expectations about the company's performance and measures how much the market is willing to pay for a share in the company's potential future earnings. Basically, a high P/E ratio indicates that investors expect that the company's earnings will grow rapidly. Growth expectations will be linked to the industry to which the company belongs. As the relative rate of expected growth in earnings differs significantly among industries, so will the typical P/E ratios for industries tend to vary. In this vein, it makes more sense to compare the P/E ratio of Peugeot SA to the P/E of Volkswagen AG than to the P/E of Microsoft Inc. A decline of the predictions of general economic conditions generally has a negative effect on the overall level of P/E ratios, because the market takes it as an indication that the earnings of virtually all companies will be affected. We will come back to the P/E ratio later.

Investors generally expect two kinds of return: appreciation of the market price of a share and dividend income. Investors who like to receive dividend income will look at the *dividend yield ratio*. It reflects the relationship between the dividends per share paid to shareholders and the current market price of a share. The ratio measures the percentage of a share's market value that is returned (annually) in cash to the shareholders.

$$\text{Dividend Yield} = \frac{\text{Dividend per share}}{\text{Market price per share}}$$

Dividend yields vary widely, from 0 per cent to 5–6 per cent. Young, high growth companies usually are reluctant to pay cash dividends, as they need the funds to finance further growth. Companies with high dividend yields are usually older, established companies. The major financial newspapers publish dividend yields of listed companies daily.