

Understanding value

In a bear market, share prices can fall indiscriminately with many companies falling well below their fair value. The result? Buying opportunities for shrewd investors.

When professional investors choose stocks, they often seek to invest in companies that have fallen below their fair value, so that they can profit when this value is reflected in the share price. But how is fair value determined?

How to measure value

There are lots of ways that professional investors look to measure the fair value of shares. A common measure is the **price-earnings ratio**, or P/E. This expresses a company's share price as a multiple of the annual earnings per share that the company is generating.

Say, for example, a company's share price is £10 and the company generates earnings of £2 per share, the P/E is 5 ($£10/£2 = 5$). If the share price rises to £20 without a change in the company's earnings, the P/E rises to 10 - twice as expensive.

Why do P/Es matter right now?

Recent stock market falls have created value in stock markets - if you know where to look.

As the chart shows, as UK share prices have fallen, the average P/E ratio has dropped sharply. In December 2008 it was just six times earnings - well below the 20-year average of 15.8 times and the July 2000 peak of 23.5 times earnings.

The fall in prices is in part justified by concern over the ability of companies to maintain their earnings amid the economic downturn. However, some companies may have fallen below their fair value - creating opportunities to buy high-quality companies at attractive prices.

Spotting value

Undervalued high-quality shares are often the first to recover as markets normalise. But it is important to distinguish high-quality companies on low P/Es from poor or struggling companies that are cheap for a good reason.

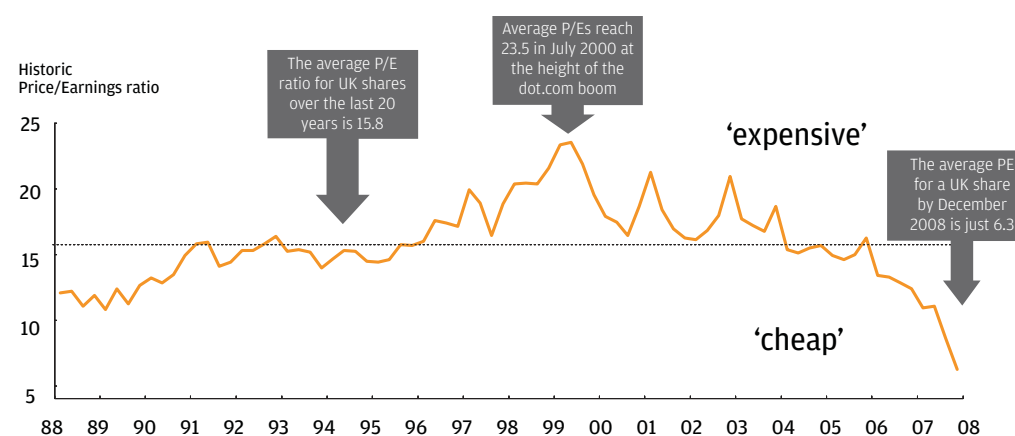
Features of high-quality companies may include:

- Clear market niche
- Market leadership and pricing power
- Strong balance sheet

Investors can access the value opportunities available in today's markets through funds that take a value approach. These funds aim to generate profits for investors as shares in undervalued, high-quality companies rise towards their fair value.

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Measuring value among UK shares 1988-2008



Source: FactSet Aggregates Index and I/B/E/S using historic P/E ratios.