WALL STREET IN WORDS AND FORMULAS

Like lawyers speaking legalese, investors have their own patois that, unless you're in on the game, can sound, if not foreign, at least like something that requires a decoder ring to decipher.

In truth, the words of Wall Street are easy to understand. And you do need a working knowledge of them, if for no other reason, to at least grasp what financial professionals are telling you when they're providing investment services. In other situations they'll help you better understand what the market pundits jabber about on the business news shows, they'll help you better analyze the individual investments you might be interested in, or help you slip effortlessly into a stock-market conversation at the next cocktail party.

There are a ton of these words and phrases that the Street relies on when speaking the language of finance. You don't need to worry about the vast majority of them unless you want to be a committed stock investor. And if you do, there are very good books that specifically focus on those intricacies, including *The Wall Street Journal Complete Money and Investing Guidebook*. For the average person, however, there are a few basic concepts with which you at least want to be familiar:

For instance, *P/E ratio*. This term is bandied about in reference to just about every stock ever mentioned. This is the ubiquitous price-to-earning ratio, a very simple-to-derive measure of how expensive a particular stock is relative to the company's earnings. A stock's price is nothing more than a reflection of how dearly or cheaply investors value the underlying company's ability to earn

profits—the primary reason any company goes into business, and the primary reason an investor wants to own shares of stock.

In general, companies with high P/E ratios are those that investors expect will continue to report robustly growing earnings, also known as net income or profit. Companies with low P/E ratios have muted growth expectations.

The formula to calculate the P/E is

P/E = Current Price ÷ Latest Four Quarters of Earnings (Price ÷ Earnings)

So, if a company's stock price trades for $20 and the company has earned in the most recent 12 months $1.25 per share—and we'll explain "per share earnings" in a moment—then it has a P/E ratio of 16 (20 ÷ 1.25 = 16).

Since that number by itself doesn't really say much, investors traditionally look at the P/E in comparison to a company's historical P/E range. If this same company historically trades in a range of 8 to 12 and it's now at 16, well the shares might be overvalued at the moment. Conversely, if the historical range is 20 to 25, then the shares may represent good value.

Net Profit Margin

The net profit margin flows directly from the proverbial bottom line because net income is typically the last—or bottom—line on a company's quarterly and annual income statements. Expressed as a percentage, this represents how efficiently a company has turned sales into profits after paying all the costs of business, such as salaries, production expenses, marketing, taxes, and the like.

Net profit margins are all over the map, depending upon the company and the industry. Many technology-intensive companies such as software makers and pharmaceutical firms boast of very healthy margins near 20% and above. That means 20 cents of every dollar in sales flows through to net profits, the earnings, which ultimately drives the stock's price. Other companies, such as those in low-tech, commodity businesses such as grocery stores, have margins of just 1% or 2% or so. This doesn't make them lousy businesses; that's just the nature of their industry. As with many investment measures, net profit margins are best examined in comparison to a company's history and in comparison to the industry in which that company operates.

The formula:

Net Profit Margin = Net Income ÷ Net Sales

Both "net income" and "net sales" are found on the "income statement," sometimes called a statement of earnings.

Yield

When you own certain stocks and bonds, you earn income in the form of dividend payments (stocks) and interest payments (bonds). Those payments, expressed as a percentage of the current price of the stock or bond, represent the yield, which is always expressed on an annualized basis.

Here's the formula:

Yield = Annual Income ÷ Current Price

So, if a mythical company that trades for $20 a share pays you $1 per share in annual dividend payments, you're earning a yield of 5% (1 ÷ 20 = .05).

Book Value

Remember the discussion earlier about calculating your net worth? Well, book value is a company's net worth; it represents the remaining cash value if the company sold off every asset and paid off every debt. This is often expressed as a per-share value, such as a book value of $13 a share.

The formula:

Book Value = Shareholders' Equity ÷ Total Outstanding Shares

You will find "shareholders' equity" and "total outstanding shares" on a company's balance sheet.

WARNING: Book value can be overstated or understated, depending upon all manner of factors—innocuous and malevolent—that companies employ. But in general, companies that trade below their book value are often seen as bargains on the theory that you could dismantle the company and create more value than the stock is currently worth. Conversely, companies whose book value is substantially above the share price—multiples of, say, five and above—are very pricey. But as with the P/E ratio, you need to know the historic range to understand the current book value in context.

PEG Ratio

This measures a company's P/E against its growth rate, the "G" in the PEG ratio. The theory: Companies whose earnings growth rate is bigger than the stock's P/E ratio may represent a bargain. If earnings are growing faster than investors are giving the company credit for (and remember that a P/E ratio is the market's estimation of the value of a company's earnings), then it stands to reason that the stock price ultimately will move higher to catch up to the earnings growth.

On the other hand, if the earnings growth rate is well ahead of the P/E, then you have an indication that investors are pricing perfection into the stock, and any perceived or real slip-up could send the shares somersaulting southward.

The formula:

PEG = P/E Ratio ÷ Growth Rate

You already know how to calculate the P/E. For the growth rate you can use one of two numbers—historic or expected. To use historic, calculate a company's year-over-year earnings growth, meaning look at the most recent earnings compared to the earnings from the same quarter a year earlier.

That formula:

growth rate = (current quarter's earnings − year-ago earnings) ÷ year-ago earnings

Or, you can go to Morningstar (at www.morningstar.com), plug in a stock symbol, and under the "Key Ratios" link find the "Growth Rates" tab that will reveal a variety of short- and long-term earnings growth rates.

If you want to use expected earnings, you'll need to find the rate at which Wall Street analysts expect a company's earnings to grow. You can find that online at Yahoo! Finance (at finance.yahoo.com), under the "Analyst Estimates" link. Yahoo! even shows the PEG ratio—if you don't want to calculate it yourself.