

The multiple: what the market pays for earnings

THE MULTIPLE

Price divided by a year of earnings: what the crowd currently pays for a unit of this company's profit. It is a sentiment gauge wearing a valuation costume - comparable only within sectors, mean-reverting only when it feels like it, and responsible for more of most stocks' price action than the earnings underneath. Reading it is crowd-reading, and the FX rules apply.

Lesson 1 split the price into machine and mood. This lesson reads the mood's number - carefully, because it looks like arithmetic and behaves like weather.

What the multiple actually prices

Mechanically, a higher multiple pays more today per unit of current earnings - which the crowd does when it believes earnings will grow, compound, and deserve low discount: growth expectations, quality beliefs and the rate environment, compressed into one ratio. All three inputs are opinions. That is not a flaw to correct; it is the object's nature - the multiple is the price of a story, and stories are what module 1's FX warning was about.

Reading it without being fooled

Within sectors only: business models set baseline multiples - utilities and software are different species, and cross-sector comparison is a category error dressed as insight. Against its own history: a name at the top or bottom of its multi-year multiple range says the story has moved - the observation worth a mechanism hunt, exactly like an FX positioning extreme. Against rates: the gravity every multiple answers to - rising rates compress the price of stories mathematically, and entire index-level moves are this one force, which the trader reading only earnings will never see coming.

The return decomposition habit

Any period's stock return splits into earnings change and multiple change, and the split is always worth computing: a stock up 40% on flat earnings did all of it on mood - the return is a re-rating, borrowed from the story's future, and it reverses the way stories do. A stock up 40% on 40% earnings growth at a flat multiple did it on machine. Same chart, entirely different risk - and the difference is invisible until decomposed, which is the whole reason lesson 1 made the split this module's spine.

Check your understanding

1. Why is the multiple 'a sentiment gauge wearing a valuation costume'?

- a. Its formula is often miscalculated
- b. Its inputs - growth expectations, quality beliefs, rate discounting - are all opinions: it prices the story, and stories are crowd objects
- c. It ignores dividends

Answer: b. The ratio is arithmetic; everything it compresses is belief. The FX toolkit - windows, extremes, crowd-reading scepticism - is the correct one, and the accounting toolkit is not.

2. Two stocks both rose 40%: one on 40% earnings growth, one on flat earnings. Why does the difference matter?

- a. The second is guilty of manipulation
- b. The second's entire return is a re-rating - mood, borrowed from the story's future - and reverses the way stories do; the first's is the machine, audited quarterly
- c. It does not - returns are returns

Answer: b. The decomposition names the risk: multiple-driven returns rest on a crowd staying convinced. Identical charts, different physics - visible only when the split is computed.