

Under PEG 1, stocks beat the Sensex by 19%. Above 3, they lagged

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Maxim: *Don't overpay for growth: the PEG test.* — Raamdeo Agrawal

A fast-growing company is not automatically a good investment. What matters is how much of that growth you are paying for in advance, and one simple ratio puts a number on it.

Growth is the most persuasive story in investing, and the easiest one to overpay for.

Every year since the mid-1990s, Raamdeo Agrawal, co-founder of Motilal Oswal, has published a study of India's biggest wealth creators. The 2018 edition, the 23rd, asked a pointed question: did it matter what investors paid for growth? To answer it, the team took 4,015 instances between 1998 and 2015 of companies worth at least ₹1,000 crore, and measured each stock's valuation against the earnings growth it actually delivered over the next three years. The yardstick was the PEG ratio: the price-to-earnings multiple divided by the growth rate. A stock at 30 times earnings growing 25% a year has a PEG of 1.2.

The results, set out in the [Motilal Oswal Wealth Creation Study 2018](#), were stark. Stocks bought at a PEG below 1 beat the Sensex by an average of 19% over the following three years. Below 0.5, the margin was 26%. Between 1 and 1.5, it shrank to 3%. Above 1.5, the stocks lagged the index, and those bought above a PEG of 3 trailed it by 10%. The study's conclusion was blunt: buying below a PEG of 1 was "supremely profitable," and stocks above 1.5 were best avoided. Among very high absolute valuations the story was worse still: stocks bought at more than 75 times earnings trailed the index by 18% over three years.

Where the idea comes from

The PEG ratio is older than the study. Peter Lynch popularised it in *One Up on Wall Street* (1989) with a simple rule of thumb: "The P/E ratio of any company that's fairly priced will equal its growth rate," as the [Wikipedia entry on the ratio](#) records. A company growing 20% a year, on that logic, is fairly priced at about 20 times earnings. Pay 40 times and the PEG is 2: you are paying double what Lynch's rule calls fair, and betting that the growth will last long enough to justify it.

Agrawal's own advice, in an [interview with Value Research](#) after the 2018 study, was more sobering than the headline numbers. "Most companies I like trade well over a PEG of two," he admitted. The trick, he suggested, was patience: waiting for good franchises to have bad quarters, so that a company like Maruti might be bought at 20 times earnings instead of 40.

The catch: growth that fades

There is an important caveat, and the study states it clearly. Its PEG calculations used the growth that companies actually achieved over the next three years. Real investors have to forecast that growth, and forecasts of fast growth are where most mistakes are made.

The same study measured how rarely hyper-growth lasts. Of 28 companies that grew profits by more than 25% a year over the five years from 1998, only 8 did it again in the next five years, and just one managed a third stretch. Of 103 such companies starting in 2003, 13 repeated the feat, and none managed it a third time. "The biggest insight from this report," Agrawal told Value Research, was that "hyper earnings growth often doesn't last beyond five-six years." A stock priced for a decade of 30% growth is often priced for something that has almost never happened.

The ratio has other limits. It says nothing about the quality of earnings, the debt behind them or the return on capital that produces them, and it works poorly for slow-growing or cyclical businesses. It is a filter, not a verdict.

Using the PEG test

Before paying a high multiple for a growth story, run it through five checks:

1. **What growth is actually priced in?** Divide the P/E by your honest estimate of earnings growth over the next three years. Above 1.5, you are paying more than history suggests is wise.
2. **Is the growth estimate realistic?** Compare it with the company's own record over the last five to ten years, and remember how few companies sustain more than 25% for long.
3. **Is the growth profitable?** Check that return on capital is comfortably above the cost of money, so the growth is creating value rather than consuming it.
4. **How high is the absolute multiple?** Above about 50 times earnings, the study found, the odds of beating the market fall sharply, whatever the growth rate.
5. **Can you wait for a better price?** Good companies have bad quarters. A watch list with target PEGs lets you act when they do.

A simple decision rule. Buy a growth stock only when its PEG, using conservative growth estimates, is around 1 or lower, and treat anything above 1.5 as a reason to wait rather than a reason to buy. Revisit holdings whose PEG has risen above about 3: the study suggests that is where future returns have usually been weakest.

The markets of 2026 have been unkind to many richly priced stocks. By late May the Nifty was heading for its first calendar-year loss since 2015 and the IT index was down more than a third from its December 2024 level, [Invezz reported](#). Repricing like that is exactly when a discipline like the PEG test earns its keep. It cannot tell you which company will grow fastest. It can tell you when the price already assumes too much, and in the study's long record, that warning has been worth heeding.

Sources

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