Market Perspectives: Value Traps

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Investors often fall victim to "Value Traps" when their traditional valuation metrics may be screaming a particular stock is a "BUY!" but in reality they would be wise to avoid the investment. Investors often look for situations where a firm's stock price is depressed and appears inexpensive relative to prior valuation metrics. The "trap" occurs when the investor purchases the stock only to find that the discounted price is a reflection of the deteriorating fundamentals of that company. To avoid value traps, an investor should recognize that something may have changed fundamentally about the business and the new depressed valuation is no longer an opportunity to enter a position. It is important to realize that a cheap price does not equal a "good value."

A good "value situation" can be defined in many ways. Our litmus test is "Would we as an investor be willing to buy the entire company (with our own money) at the valuation implied by the current price of the stock?" Assessing the durability of the underlying business is one of the most important processes for us. This would include an "economic moat" which is the sum of competitive advantages that allow a business to sustain itself and to grow. If in using our litmus test, we find a company that we would be willing to pay a price above the current one, we limit our downside risk while enhancing our upside potential. This is how we define our "margin of safety."

Financial strength is always important, but does not imply that a company should be debt-free. If cash flows are relatively stable, then the use of borrowed money as part of the capital structure is appropriate. Dry powder (cash on hand) is a good thing, and having the financial flexibility to capitalize on future opportunities will create value over the long term.

VALUE OR TRAP?

- Are business fundamentals strong?
- Is there a competitive "economic moat"?
- Would we be willing to pay a price above the current one?
- Would we buy the entire company?

In summary, whether a stock has been either higher or lower than its current price is not the most important factor in finding good value. The litmus test described earlier is essential for us in determining if potential risks and returns outweigh the value of the business as implied by the current stock price. The cheaper a stock is – that has strong fundamentals and a wide economic moat – the less potential downside and the greater the reward. The larger the margin of safety, in our opinion, the better.

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