How Can You Avoid Value Traps In this Market?

January 25, 2016
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Introduction

When the stock market turns bad, like it has been recently, investors find it extremely difficult to remain positive. As a result, people tend to be more cynical during bad times than they would normally be during better times. When this happens, it becomes all too easy to paint every stock in the stock market with the same negative brush. Since most stocks will, temporarily at least, experience falling prices during a bad market, the distinction between good stocks and bad stocks can become blurred.

As someone that believes in value investing, most of my work is focused on identifying strong and sound companies at attractive valuations. As I’ve written in the past, stocks do not become attractively valued when they are popular. But more importantly, popularity is not always justified by strong enough fundamentals, just as unpopularity can occur in spite of strong fundamentals. Nevertheless, one of the most common refrains I often run into when I write about what I believe is a strong company that has become attractively valued is someone will call it a “value trap.” Of course, this comment is typically applied when and because the company’s stock price has fallen.

Nevertheless, since I am typically writing about companies that I believe are fundamentally strong and healthy, I tend to react to the phrase “value trap” with cynicism of my own. If I see a good company that I believe the market is valuing too low, I see it as a “value opportunity.” However, my judgment is always based on my assessment of the company’s true fundamental value regardless of stock price. In contrast, and in my personal experience at least, the vast majority of the time that people call a company a value trap is predominantly based solely on a falling stock price.

In reality, there are low valued stocks that are in truth value traps, and there are low valued stocks that are in truth value opportunities. Making the distinction is not always straightforward and easy. However, when you get it right, the profit opportunities can be extraordinary. In other words, if you can successfully identify a true value opportunity, you can make outsized returns at reduced levels of risk. In contrast, if you mistakenly invest in a true value trap, you end up with outsized losses at significantly higher levels of risk.

The Definition of Value Trap

I believe the most important step towards avoiding value traps is to start by precisely defining what a value trap actually is. The reason I believe this is so important is because I have personally found that many people have a vague definition of what a value trap truly is. For example, here is one definition for value trap I found simply through Google:

“INVESTOPEDIA DEFINITION of ‘Value Trap’

A stock that appears to be cheap because the stock has been trading at low multiples of earnings, cash flow or book value for an extended time period. Stock traps attract investors who are looking for a bargain because these stocks are inexpensive. The trap springs when investors buy into the company at low prices and the stock never improves. Trading that occurs at low multiples of earnings, cash flow or book value for long periods of time might indicate that the company or the entire sector is in trouble, and that stock prices may not move higher.”

Notice how the above definition focuses heavily on stock price movement. Important fundamentals such as earnings, cash flow and book value are vaguely alluded to in the opening sentence. However, from that point forward the focus turns to stock prices. Indistinct statements about low prices that never improve, trading and long periods of time, and stock prices may not move higher, do not satisfactorily define the term for me. The above definition talks too much about price and not enough about intrinsic value.

Admittedly, fundamental deterioration is perhaps alluded to, but in my opinion not focused on or clarified enough. For me to consider a company a value trap, I have to believe that there is a permanent long-term deterioration in the future fundamental strength and health of the company. To me, a company becomes a value trap when either it’s on the verge of
going out of business, or poised for a long protracted period of collapsing or even disappearing earnings, cash flows, and inevitably dividend cuts or elimination.

The purist value opportunity manifests when earnings, cash flows and dividends continue to grow or improve in spite of current price weakness. It is for these reasons that I believe in focusing on fundamentals first and foremost, with the primary objective of evaluating a company’s intrinsic value. Once this is accomplished, and only when it is accomplished, will I even consider bringing price into the analysis. When I am confident that the current stock price is lower than my assessment of intrinsic value, I see opportunity, not a trap.

However, value opportunities can also be found with cyclical or semi-cyclical companies as well. What makes these a little trickier is that both earnings and/or cash flow can be in a temporary down cycle in conjunction with a falling price. The value opportunity occurs when price drops farther than temporary or cyclical fundamental deterioration warrants. In other words, the market overacts to normal cyclicality. This is where focusing on the dividend can identify a value opportunity rather than a value trap. If the dividend continues to rise in spite of cyclicality in earnings, attractive value is created representing opportunity, not a trap.

**During Market Times Like These Remember Profitability Is A Major Component of Value**

With this article my objective is to illustrate the important distinctions between a value trap and a value opportunity. However, I’m going to try to keep it simple by offering two examples, one I consider a value opportunity and the other I consider a quintessential example of what a value trap truly is. Since a picture is worth 1000 words, I will present these examples by utilizing a series of earnings and price correlated F.A.S.T. Graphs™ on each.

**Pentair plc (PNR): Example of a Value Opportunity**

By my definition, a true value opportunity occurs when the price of a stock falls below its intrinsic value. However, the sequence is in reverse. Before I even think about the price of a company, I focus my attention on its fundamental strengths as an operating business. Since my objective is to invest in the business, not the stock, I like to get a perspective on how business has been long-term.

The following earnings and dividends only graph on my first example, the Dividend Champion Pentair, serves to illustrate my point. From an earnings perspective I see occasional periods of earnings cyclicality, but long-term I see a profitable and growing enterprise. More importantly, since my primary interest in this business is based on its current yield and long-term dividend record, I am very impressed by what I see. The honeydew green (white looking) line on the graph plots dividends per share since 1996. The consistent and steadily-growing dividend is precisely what I’m looking for.
Once I've established a long-term perspective, I turn my attention to more recent times. By shortening the timeframe from 2011 to current time I discover healthy growth of earnings, and a dividend income stream that has been growing at approximately 10% per annum. Therefore, although the long-term record for this Dividend Champion was impressive, more recent earnings and dividends add to my confidence.

Furthermore, upon examining the rate of change of earnings growth for each successive year (Chg/Yr) a couple of interesting facts come to my attention. For fiscal years 2013 and 2014 Pentair produced earnings growth of 34% and 18% respectively (see orange highlights). I also found it interesting that those earnings achievements followed a rather flat to slightly down 2012 earnings achievement.

But what really caught my attention were the estimates for 2015 (which should be reported in the next few weeks) and the estimates for 2016. Earnings growth for 2015 will be tepid at approximately 2% relative to 2014’s 18% growth, with slight improvement estimated at 6% for 2016 (see yellow highlights). Common sense suggests that those numbers could be disappointing to investors after following two excellent years of high growth. At this point, I’m beginning to wonder what stock prices will look like relative to those fundamentals.
Now it's finally time to bring stock prices into the equation. I have established that this is a profitable company with a great dividend record, but I am also aware that earnings growth is expected to temporarily slow down a little over the next couple of years. Common sense would also suggest that the slowing of growth could have an impact on intermediate-term dividend growth as well. Consequently, I now have a perspective that investors might be disappointed by those expectations.

Therefore, my next step is to overlay monthly closing stock prices on to the long-term graph in order to establish a perception of how the market has historically valued this business based on fundamentals. For the long-term perspective, I discover a very strong correlation between price and earnings over time. Additionally, I see brief periods of time where price becomes overvalued relative to earnings but quickly move back into more rational alignment.
When I once again shortened the timeframe but now include both earnings and price, I get a chance to analyze and evaluate the earnings and price relationship more clearly. Here is what I deduce and assess from the facts as they are presented. Stock price (the black line) rose strongly in 2013 on the strength of 34% earnings growth and valuation stayed high for most of 2014 (on February 28, 2014 P/E ratio peaked at 24.5) but waned a little as earnings growth of 18% for 2014 was lower than the previous year. More simply stated, stock price was strong when earnings growth was strong. However, as earnings weakened in 2015, the stock price reacted by drifting steadily lower throughout 2015. Although I consider this rational behavior for the most part, I also observed that the negative price action moved to the extreme. In other words, stock price fell farther than earnings results justified they should. Once the price went below the orange valuation reference line, I contend that a value opportunity is manifesting.
I applied a little deeper analysis by turning to FUN Graphs in order to review the 2015 quarterly earnings releases that have been reported thus far. This analysis further supports the reasonableness of the continuously falling 2015 stock price based on the fact that Pentair’s 2015 earnings became slightly weaker with each passing quarter. In other words, this helps me understand why 2015 was a weak stock price performance year. Valuation was high based on the euphoria generated by strong earnings growth in 2013 and 2014, but 2015’s weaker results dampened investors’ views. However, as previously stated, I believe that price has fallen too far creating a value opportunity.
My bottom line conclusions on Pentair based on the above analysis suggests a strong opportunity to purchase this Dividend Champion at a currently attractive valuation. In the past, the long-term view suggests that periods of earnings weakness are often followed by periods of earnings strength. Moreover, although earnings growth has slowed down a little, the company is still profitable and still growing. Therefore, I believe the dividend is safe and very likely to continue growing as it has in the past. Consequently, I consider this company a value opportunity and worthy of the effort of a more comprehensive research and due diligence process.

**Avon Products Inc. (AVP): Example of a Value Trap**

As I previously suggested, I consider a company a value trap when there is a long and protracted period of fundamental deterioration. On occasion, I will accept a down year, however, I am very intolerant of a dividend cut. Clearly, as evidenced by the following graph, Avon has generated a steady decline of earnings since the end of 2008.
When monthly closing stock prices are added to the complete F.A.S.T. Graphs™ it is no surprise that stock price followed, nor is it a surprise that the company slashed its dividend. This is what a true value trap looks like, and it is materially different than what we saw above.

However, here is the interesting point about whether or not low valuation alone indicates a buying opportunity. I added a performance calculation from September 30, 2011 to current. The first pop up on the graph indicates that Avon was trading at a low P/E ratio of 11.7 at that time. This is lower than my typical fair valuation threshold of a 15 P/E ratio, but that alone does not indicate low value. The P/E ratio calculation was made on current earnings, and although it was low on that basis, it was extremely high on a forward earnings basis. Avon was a value trap because you would have lost approximately 78% of your investment to date, including dividends - because earnings continued to collapse.

**Bonus: Overvaluation Trap: V.F. Corporation (VFC) A Falling Stock Price Does Not Create a Value Opportunity Until It Does**

Since this article is primarily addressing value traps, there is another kind of value trap that I believe is mostly unrecognized by many investors. This is what I refer to as an overvaluation trap. However, in this case the trap is not sprung by deteriorating fundamentals. Instead, it is the trap that many investors fall into when they overpay for a company with strong price momentum above what fundamentals would justify.

Even though this market is recently going through a significant correction by most people’s standards, it does not simultaneously follow that all stocks are getting cheap. This especially applies to the retired dividend growth investor that covets Dividend Champions and Aristocrats. My analysis suggests that several Dividend Champions and Aristocrats have become significantly overvalued as a result of the recent long stock market’s bull run. Some of them have already experienced moderate to significant price corrections in 2015 and thus far into 2016. Unfortunately, many still remain...
significantly overvalued based on fundamentals.

What frustrates me is the fact that some of my favorite businesses have currently entered the overvaluation trap category. Some of the more prominent names would include Kimberly-Clark (KMB), Hormel Foods (HRL), Sherwin-Williams (SHW), McDonald’s (MCD) and Walgreens Boots Alliance (WBA). However, the company I’m featuring in this bonus section is V.F. Corporation because it is a long way into its correction process. Therefore, VFC represents a classic example of an overvaluation trap that has been sprung.

As you examine the following earnings and price correlated graph, note how high valuation had gotten in 2014 and for most of 2015. Then further note how flattening earnings in 2015 brought valuations down to a more realistic level. When a company becomes overvalued, stock price becomes exposed to even the slightest bit of negative news.

The company is clearly a better valuation today than it was just a few short months ago. Moreover, current valuation could be reasonable enough to warrant consideration for the long-term ownership. On the other hand, I would still not consider it a significant valuation opportunity. Nevertheless, the purpose of this example was to illustrate the reality of an overvaluation trap.

Summary and Conclusions

When you discover companies trading at low P/E ratios you cannot automatically assume that they are attractive. If future earnings are expected to fall, and worse, if they are expected to fall for an extended period of time, then a low valuation could in fact be a value trap. On the other hand, if you discover a company trading at a low P/E ratio that possesses healthy fundamentals, this could represent a valuation opportunity. It’s important to make the distinction. Of course, the primary way to make that distinction is through comprehensive research and due diligence.

However, not all value traps are associated with apparent low P/E ratios. Overvaluation traps can also be dangerous to long-term results and represent taking on more risk than you should. In my experience, more people fall into overvaluation traps than low valuation traps. The former is rarely given consideration, and too many people eschew bargains when they appear, at least in my opinion. My advice: Do your homework and make your decisions on facts rather than emotions or opinions. And most importantly, never let irrational short-term price movements drive your investment decisions. You can’t predict them, or trust them.

Disclosure: No position at the time of writing.

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