How To Avoid a Value Trap: Part 2

Description

In a previous article, we outlined three ways to avoid the dreaded “value trap”, in which a stock appears really cheap, only to become a lot cheaper.

These kinds of traps have cost a lot of very smart people a lot of money. But there are certain steps you can take to give yourself a better chance at avoiding them. Below we present three more of these steps.

1. Look for hard asset values

Very often, you’ll hear a stock referred to as “cheap” just because it has a low price/earnings ratio. But that doesn’t make a stock cheap at all, especially if earnings are in decline.

It’s a lot different when a business trades below the fair value of the assets it already owns. For example, a retailer might trade below the value of its real estate and inventory. A mining company may trade below the replacement cost of its mines. A house may trade below its construction cost. Or maybe a contractor is trading below the present value of its existing contracts. These types of situations lead to a more reliable floor value than a measure based on past earnings.

An example of this may be **Sears Canada Inc** (TSX: SCC), which holds very valuable real estate and store leases. New CEO Douglas Campbell announced in late April that he is open to more asset sales after generating $591 million through such sales over the past year alone. So even if the company’s turnaround is unsuccessful, the hard assets can indicate a more predictable floor value for the stock.

2. Just wait for the turnaround

A lot of value investors specialize on betting on turnarounds. And when successful, these investors can hit some real home runs. But it’s a very difficult dangerous game to play.

A better strategy is often to wait for the turnaround to show signs of success. This is because some companies are so hated that it takes a long time for investors to trust the company again. Thus the stock price may not recover as quickly as it should, giving you an opportunity to scoop up the company at a bargain price.

This may be the best strategy to take with a company like **Barrick Gold** (TSX: ABX)(NYSE: ABX). Numerous operational failures, a sagging gold price, and governance issues, have caused many investors to swear off the company forever. So if Barrick eventually becomes a great company, there may be an opportunity to buy it at a discount.

3. Look for long-term targets

One truth will always remain when it comes to most investors. They want results right away. So when a CEO starts talking about increased costs in the near future paying off over the long term, the share price often goes down. But if you're willing to be patient, that may present an opportunity.

A good example of this is **Blackberry** (TSX: BB)(Nasdaq: BBRY). The company seems to be on the road to recovery after having once been Canada's biggest value trap. But every time CEO John Chen says that this will take a lot of time, the stock seems to fall. So if you believe in him and the company, those are the opportunities you should be looking for. As long as you're willing to wait.

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