Home Capital Group Inc.: Just Because it's Cheaper Doesn't Mean it's a Value Play

Description

One argument I hear a lot from those considering buying an investment for the first time, or those trying to time the market and pick a "good entry point" on a stock, is if the price-to-earnings (P/E) ratio on a given stock is below the industry standard, that means it must have value and be oversold; the fact that the company's stock price is trading at a relative discount to the average firm in a given industry is a signal to "buy now."

I'm going to take the example of **Home Capital Group Inc.** (TSX:HCG) to show why this argument is erroneous and can be potentially very dangerous.

Differentiate between cheap and fundamentals

The first thing to clarify with new investors or those with less experience is that cheap doesn't equate to value. Buying a broken-down lemon of a vehicle for half the price of a newer vehicle doesn't change the fact that the vehicle purchased is still a lemon. The owner of the vehicle paid half as much but is likely due for more than double the pain in the journey ahead.

The underlying fundamentals of the business in question needs to be thoroughly inspected. Just considering the sticker price and what other people "think" about the company is very dangerous and can prove to be very costly in the long run.

My latest article on Home Capital Group goes into detail regarding the underlying fundamentals of the business, providing a high-level "40-point inspection" to show you what I think about the business as it stands today.

As mentioned, should business conditions improve and/or some of the issues plaguing the company be dealt with over the coming quarters, I will be happy to revise my opinion. For right now, Home Capital Group doesn't appear to have any attributes I would deem investment-worthy based on its fundamentals. At least, not for a long-term investor such as myself.

The market is much smarter than you and me

What is amazing about financial markets is the fact that millions of people are simultaneously trading thousands of stocks on a daily basis, providing companies with real-time valuations and estimates of risk and return for each company. In general, if the market is pricing in a lower P/E ratio for a given stock, it means it is, at the same time, pricing in a higher-risk premium on the company.

You can’t have an increased return without more risk.

The fundamentals of finance hold true, and sometimes it is good to go back to basics when thinking about what “value” means when referring to companies.

Stay Foolish, my friends.

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