Investor Beware: Equitable Group Inc. Is Still a Value Trap

Description

Equitable Group Inc. (TSX:EQB) is an alternative mortgage lender that is down a whopping 43% since the warning I gave earlier this month. Marc Cohodes, a short-seller made famous for his bearish calls on many infamous Canadian companies, believes that Equitable Group is a "poor man's **Home Capital Group Inc.** (TSX:HCG)," and I think he's right on the money. Home Capital Group was in turmoil last week, and this was enough to send all alternative lenders like Equitable Group crashing.

In my previous piece, I mentioned that Equitable Group was a value trap which could cause many investors to lose their shirts. Based on traditional valuation metrics, Equitable Group is one of the most misleading stocks out there. The company had a ridiculously low eight price-to-earnings multiple when the stock was around its 52-week high, and given the positive momentum, it appeared that Equitable Group was a fantastic value play that was set to soar.

The price-to-book multiple was also ridiculously low, and the ROE was at a very impressive 21% before Equitable took a plunge. If you didn't roll up your sleeves and do your homework and just relied on traditional valuation metrics or technical analysis to determine if Equitable Group was a good buy, then you probably would have loaded up on shares.

Value traps like Equitable Group are dangerous for beginner DIY investors in particular, because it's difficult to analyze a company without relying on some sort of metric. For example, many beginners may abuse the price-to-earnings or price-to-book multiples when attempting to find undervalued stocks.

Finding value in the markets isn't this simple. There's no rule of thumb, and traditional valuation metrics like the price-to-earnings multiples are useful tools for supplementing your analysis, but coming to conclusions based on these metrics alone is very reckless, and you could end up steering yourself in the direction of a value trap like Equitable Group.

After the huge plunge last week, Equitable Group is now has a dirt cheap 4.3 price-to-earnings multiple, which may seem like a steal, but it really isn't. If it's too good to be true, then it probably is, and you need to find out why the company is "cheap," because a lot of the time a stock is dirt cheap because it's going to experience a decrease in its earnings, which will correct the price-to-earnings multiple down the road.

Equitable Group's portfolio contains extremely risky mortgages that the big banks wouldn't touch. Sure, riskier mortgages come with higher rewards, but in the event of a housing collapse, defaults will become abundant, and that sky-high ROE will inevitably come crashing down.

Equitable Group is exposed to the weak Albertan economy as well as the overheated Vancouver and Toronto housing markets, which many pundits believe are in bubble territory. This is taking the risk to another level, and the odds are extremely high that you'll lose a majority of your initial investment.

Equitable Group is not cheap — it's a value trap, and more downside is likely ahead, even after the massive plunge last week. A short squeeze is possible, but unless you're an experienced trader who is fearless, you should probably just forget about Equitable Group completely.

Some falling knives are just meant to hit the floor.

Stay smart. Stay hungry. Stay Foolish.

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