Beginner Investors: Here's What a Value Trap Looks Like

Description

In this article, I'm going to talk about value traps, what they are, and how to spot them. To do so, I've picked two stocks which happen to be topical of late: **Genworth MI Canada Inc.** (TSX:MIC) and **Home Capital Group Inc.** (TSX:HCG).

What is a value trap?

A value trap is a stock which, on the surface, appears to investors to have significant value (is cheap) compared to its peers. Such a stock can give the appearance of value in a number of ways: the stock can have unusually low earnings/book multiples, a low price-to-sales ratio, higher-than-usual free cash flow generation, or it can be valued below its book value for a short (or even long) period of time.

Many investors in such a stock thus feel "trapped" because as the stock's price continues to decline, it appears more and more attractive, or cheap, using traditional measures of value.

This illusion of value creates a scenario in which investors who'd bought in at "value" levels often have trouble ridding themselves of a position that continues to decline and may not recover.

Value traps to avoid

First of all, a big shout-out should go to Fool contributor Nelson Smith, who accurately portrayed both Home Capital and Genworth as value traps in an article written almost a year ago at a time when anyone suggesting that weakness in the Canadian housing market could be on the horizon was almost certainly ridiculed.

Home Capital's stock has declined substantially due to an array of scandals of late. These pieces of "bad news," taken together and over a period of time, have led to a deterioration in the equity valuation of the company, despite seemingly "strong" fundamentals. It seems that Mr. Smith was correct in his assessment of the market and how the fundamentals may change over time, affecting both Home Capital and Genworth.

Since the beginning of the year, Home Capital has lost three-quarters of its value and more than 85%

of its value from its peak in 2014, meaning value-seeking investors lured by this value-trap opportunity have been hit very hard.

In many cases, investors look to the past to project what the future may hold; I would contest that readers should continue to look to contributors such as Mr. Smith for analysis of what the *future* may hold, as this sort of analysis can help investors make good long-term investment decisions. Value traps, as we have seen with the debacle of Home Capital, can be very dangerous for long-term investors.

With the recent sell-off of Home Capital and other alternative lenders, such as **Equitable Group Inc.**, private mortgage insurers such as Genworth have been hit hard by Mr. Market of late. While Genworth contests that Home Capital-originated mortgages account for only 1% of the company's overall business, it is important to reiterate Mr. Smith's insight into the Canadian housing market: no bull market can last forever, and Genworth happens to be one of the companies most exposed to any sort of systemic or national downturn in Canadian real estate.

Bottom line

Home Capital and Genworth are two companies that happen to be overly exposed to a potential housing correction in major Canadian markets. While both companies currently trade below book value with extremely attractive multiples, they may continue to feel the pain moving forward should a housing correction materialize. As such, I remain on the sidelines.

Stay Foolish, my friends.

CATEGORY

1. Bank Stocks
2. Investing
3. Stocks for Beginners

TICKERS GLOBAL

1. TSX:HCG (Home Capital Group)

PARTNER-FEEDS

1. Msn
2. Newscred
3. Yahoo CA

Category

1. Bank Stocks
2. Investing
3. Stocks for Beginners

Date
2025/08/05
Date Created
2017/05/03

Author
chrismacdonald