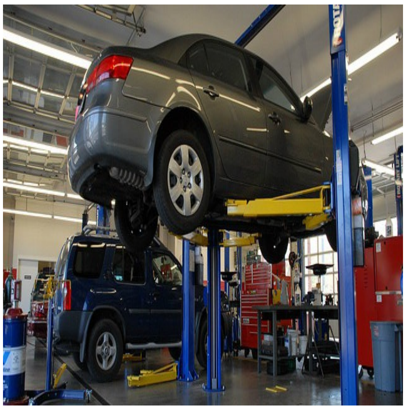

Why I'm Avoiding Magna International Inc.

Description

Magna International Inc. (TSX:MG)(NYSE:MGA) is a global automotive supplier which took a 4.55% plunge last Friday as analyst downgrades came in across the board. If you're a value investor, then Magna probably looks like a steal with its 7.89 price-to-earnings multiple, but when you consider the headwinds, this cheap stock could certainly get a lot cheaper, and you could lose your shirt if you hold Magna during the next cyclical downturn.

I think Magna is a great example of what a value trap is, and if you're a fairly new value investor, it might be worthwhile to go the extra mile to determine if stock's dirt-cheap valuation is too good to be true.

The price-to-earnings multiple is one of the first metrics that a beginning value investor may learn. It's a terrific valuation metric that many analysts use to supplement their research, but, like any other metric, it can be abused if not used properly.

A beginner investor may use a screener to find stocks with the lowest price-to-earnings multiples and load up on them, but this is a risky strategy that is likely to result in a great deal of confusion and disappointment over medium to long term.

Why is the stock so cheap?

The price-to-earnings multiple is absurdly low because the general public believes the company's future earnings could lag due to potential risk factors.

Just because you buy a stock with a single-digit price-to-earnings multiple doesn't mean the stock must go up. If future earnings lag, and the stock price stays the same, the multiple will go up, and you'll witness a "cheap" stock become "expensive" without any sort of capital appreciation.

Donald Trump's protectionist policies could be a major long-term headwind that could send Magna to even lower levels from here. A NAFTA renegotiation may be in the cards, and if a hefty border tax is put in place, foreign auto parts makers like Magna will be set to take a plunge. It's quite early in the game to understand the real impact of such a policy, but I believe Trump has the bargaining power, and the tax bill could potentially be detrimental to shares of all Canadian auto parts makers.

Magna may have no choice but to move production from Canada to the U.S. to avoid border-readjustment taxes. It's definitely going to be a capital-intensive move and, frankly, I don't think the auto parts makers are cheap enough, considering the headwinds and uncertainty following them.

We're also in the late stages of a bull market, and if a market correction happens, Magna will be hit extremely hard, as we witnessed during the last recession when the stock tumbled over 70%.

The stock may seem cheap, but I don't think we've seen a bottom yet, and things could get a lot uglier from here. Unless you're an aggressive investor who thinks the border-tax issues are overblown, I'd avoid Magna and other Canadian auto parts makers like the plague.

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