3 Tips That Will Help You Avoid Value Traps

Description

Value investing is a popular style of investing, and one that has been used successfully over decades by the likes of Warren Buffett, Benjamin Graham, and Seth Klarman.

Value investors will typically look for stocks that are trading at low-price multiples or high dividend yields.

For example, a stock like **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) would be favoured by value investors among the Canadian banks, as the company's price-to-earnings (P/E) ratio at 10.3 times is the lowest among the bunch. Additionally, CIBC's dividend yield currently sits the highest at 4.5%.

Yet there are simply no free lunches when it comes to investing, and if it were as simple as only buying those stocks that trade at the lowest multiples and the highest dividend yields, we'd all by the pool, sipping on margaritas and watching the money roll in.

As with any form of investing, there are pitfalls that value investors need to be wary of to achieve investment success.

Beware of deceptively low multiples

Sometimes a stock will trade at such a low multiple that the value being offered is dangerously deceptive.

For example, **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) trades at a forward P/E ratio of 2.5 times, which is well below its peer group and suggests investors can expect to be paid back in under three years.

But sometimes things that are cheap are cheap for good reason.

Valeant as of late has seen its business model come under tremendous pressure, and the company's extraordinarily low P/E multiple fails to account for the risk the business and the mountains of debt on the company's balance sheet.

That doesn't mean that shares in Valeant aren't a good investment; it just means there's more going with the company than initially meets the eye.

Is the company undoubtedly going to be bigger in 10 years?

Sometimes a company appears to be cheap based on its historical performance, yet there are headwinds facing the company or its industry that suggest those previously achieved results will not be repeated.

GameStop Corp. (NYSE:GME) trades at a P/E ratio of six times and a dividend yield of 7.62%, which looks great on the surface, yet a deeper dive on the company suggests that in the future, video games will be sold and delivered over the internet and not through the retail stores that the company owns.

While the dividend is attractive, investors should be careful to avoid "chasing yield" only to see the value of their investment vanish into thin air.

Watch out for companies that are employing financial engineering techniques

This is a relatively new phenomenon, but it's just as important as the first two points.

Over the past 10 years, share repurchases have become a more widely accepted method of returning capital to shareholders. The company uses cash to retire shares outstanding, which effectively lowers its share count.

There's nothing inherently wrong with this practice on its own, except that sometimes a company will use share repurchases to mask the underlying performance of its business.

A good example of this would be **International Business Machines Corp.** (NYSE:IBM). Over the past 10 years, it's spent over $100 billion in share buybacks. During that same period, the company has seen its earnings per share (EPS) rise from $7.32 to $12.43 for a nearly 70% increase.

A deeper dive behind the numbers shows that while earnings per share increased by 70%, the company's net income increased, but by a much smaller figure — just 3.9%.

The problem arises when an investor sees EPS growth of 70% and expects the business is in good shape, but fails to appreciate that that figure has more to do with financial statement manipulation than a healthy, growing business.

Conclusion

A successful value investing strategy that earns returns of 15% per year has the potential to turn $100,000 today into over $1.6 million 20 years from now. So, maybe there is hope to be sitting by the pool sipping cocktails after all.

But investors should be cautious of these common value investing pitfalls so as to avoid losing their shirt and getting burned along the way.

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