3 Danger Signs to Help You Avoid Losing Money

Description

While finding the right shares in which to invest is of great importance to investors, avoiding the stocks that can lose you money will also boost portfolio performance.

Certainly, it is always easy to see why a company's share price declined after the event. And while predicting 'losing' shares is not an exact science, there are a number of danger signs which can suggest that total returns may be negative in the long run.

High debt

While the last decade has seen interest rates generally fall across much of the developed world, a new era of tighter monetary policy is now taking shape. Already, the US has increased interest rates and the ECB is set to tighten its monetary policy stance in the Eurozone next year.

This could make life much more challenging for companies which have high levels of debt. In recent years, a number of stocks with balance sheets that are highly leveraged have essentially been propped up by a low cost of borrowing. This has meant that instead of being punished for their over exuberance prior to the financial crisis, they have been given a lifeline that has kept them in profit.

Now, though, the situation is changing and highly-indebted companies could see their profits squeezed by increased debt-servicing costs. As such, it may be prudent for investors to hold stocks which have low debt levels and ample headroom when making their interest payments.

Enthusiastic acquirers

The period of low interest rates in the last decade has also made it cheaper to buy other companies. This has led to a significant number of acquisitions, which in some cases have been somewhat questionable.

Although it can take time for synergies attached to a deal to be delivered, under-performing acquisitions are a danger sign for investors. They show that a company may have run out of ideas in terms of how to generate organic growth. They may also provide evidence that there is a lack of growth potential within the industry as a whole. Or, they may indicate that company management is more interested in company size rather than profitability and efficiency. Whatever the reason, companies that have a poor track record of acquisitions should be avoided.

Dividend cover

Another potential danger sign for investors are companies that lack sufficient headroom when paying their dividends. In some cases, a low dividend coverage ratio is acceptable if the company in question operates in a stable industry such as utilities or tobacco. However, in recent years there has been a trend towards paying out rapidly-rising dividends in a range of industries, as the loose monetary policies pursued by Central Banks has caused confidence among company management to increase.

The result is that some companies may be required to slash dividends by a significant amount if the economic outlook deteriorates in future. As such, while a high yield may be attractive, a lower and more affordable dividend may prove to be more appealing in the long run.

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