1 Severely Undervalued Bargain Stock and 1 Value Trap

Description

Beginner investors need to be wary of potential value traps, many of which are disguised as undervalued stocks that have a great deal of upside. A price-to-earnings (P/E) multiple is a great tool for investors to get a gauge of a stock's valuation, but it's not the only metric that should be relied on. It's simply another metric that's meant to supplement your analysis.

Many newcomers to the do-it-yourself investing game are susceptible to making the mistake of buying seemingly cheap "cigar butt" stocks that appear cheap based on a price-to-earnings multiple. Anybody can run a screen to filter out the low P/E stocks, but it takes an experienced and calculated investor to tell the difference between a wonderful business that's trading at a discount to its intrinsic value and a toxic stock that's cheap for a reason.

As a do-it-yourselfer, you need to roll up your sleeves and ensure you do the proper homework that's involved if you want to uncover undervalued gems. There are a tonne of gems on the TSX, but to find them, you'll need to do a lot of digging. There are no shortcuts, but make no mistake about it: the opportunities are there if you're willing to look for them.

At the time of writing, the TSX index stands as one of the cheapest indices on the planet. There are reasons for this; however, many wonderful businesses are being unfairly beaten up, and if you can uncover them and back up the truck, you could certainly become very rich by hanging on to such gems over the long haul.

How do you tell the difference between an opportunity of a lifetime and a trap?

Telling the difference between a cigar butt and a wonderful business that's unfairly discounted isn't an easy task, but it's a skill that can be learned. The more you practice, the better you'll become, but you should expect to make some mistakes along the way. But don't fret; misses happen, even to the best investors.

To tell the difference between a value trap and a bargain, you need to think in the grander scheme of things. You need to find the reasons why a stock is so cheap and make a judgement call on whether or not your long-term thesis will be affected by the reasons that have been dragging down the stock price in the near term. Oftentimes, short-term "noise" could make a wonderful business cheaper than it is; however, it can be notoriously difficult to tell the difference between noise and a detrimental issue that could hurt a company's long-term prospects.

Consider the following two dirt-cheap stocks with single-digit P/E multiples: **Equitable Group Inc.** (TSX:EQB) and **Air Canada** (TSX:AC)(TSX:AC.B). Both seem like steals at current prices, but one, I believe, is a trap, and the other is an opportunity. Can you tell which one's which?

If you do your homework, you may be able to spot the bargain from the cigar butt, but if you can't, there's no shame. It's not an exact science; it's an art — one that you'll become better at in time.

Equitable Group and Air Canada have trailing P/E multiples of 6.62 and 3.65, respectively. Both seem too cheap to be true, but the cheaper stock, Air Canada, appears to be the bargain, and Equitable Group is the cigar butt. Why? Air Canada has been plagued by short-term issues like rising oil prices and other expenses for the betterment of its long-term cost efficiencies, whereas Equitable Group is in the extremely high-risk business of alternative lending, where ROEs are inflated.

Air Canada has been plagued by short-term issues, but if you consider the big picture, the airline is poised to become more robust over the next few years, and given that the cyclical upswing is far from over, Air Canada is still a solid bet at these bargain-basement prices.

Equitable Group, however, doesn't possess the margin of safety you might think it given its cheap valuation. The nature of its industry is extremely high risk, and I believe no investor should subject their portfolios to such risks if they're long-term investors looking to snowball their wealth through the decades.

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