Beginners: Don’t Get Caught in This Value Trap!

Description

Falling into a value trap is never fun, especially if you’re a new investor who’s choosing to become a do-it-yourself stock picker. In this day and age, there are a tonne of resources at your disposal, so there’s never been a better time to be a self-guided investor, especially since you have the potential to outperform many of the “professional” money managers who command obscene fees, typically hovering well above the 2% MER mark.

Moreover, being a do-it-yourself investor can be tricky, especially if you’re just getting started. You may have learned about the concept of value investing, a strategy that has worked very well for Warren Buffett, the greatest investor of our generation. But you may not know that some stocks out there possess seemingly attractive metrics from a valuation standpoint; however, there are still dangerously risky stocks whose margin of safety is nothing more than an illusion which acts as a siren song to bargain-hunting investors.

How can one avoid such value traps? Well, as a new investor, you’re going to need to consider both sides of the coin. You’ll need to consider the bear case in addition to the bull case, even though, in your mind, you only see the bull case playing out; otherwise, you wouldn’t have considered going long a particular stock in the first place.

By considering the bear case, you can better understand the potential risks that you’ll be taking on, and you’ll know precisely when to throw in the towel should your long-term investment thesis change in the event of a sudden, unforeseen event or development.

Consider **Equitable Group Inc.** (TSX:EQB), a seemingly attractively valued stock that appears severely undervalued with its mere 5.94 trailing price-to-earnings (P/E) multiple, which seems like absolute gold for any bargain hunter. However, the stock is a value trap, and if you’re chasing P/E multiples blindly, you stand to walk into some of the most dangerous value traps that have been set across the TSX.

Single-digit P/E multiples may indicate huge value, but if the P/E multiple is too good to be true, well, a lot of the time, it is. Every cheap stock is cheap for a reason, and with such extremely low P/E stocks, either the downside risk is astronomically high, or earnings growth stands to be severely stunted.

In the case of Equitable Group, the company is in the high-risk business of alternative mortgage lending , which may command an above-average ROE, but when things go wrong, they really go wrong, as we witnessed early last year when **Home Capital Group Inc.** (TSX:HCG) imploded, bringing the broader basket of alternative lenders down with it.

Unlike fellow alternative lender Home Capital, however, Equitable Group doesn't have the comfort of knowing that Warren Buffett may be there for a bailout should another liquidity crisis happen. Add the fact that short sellers like Marc Cohodes are trying to bring the stock down, and you have a formula for a potential disaster that could suddenly blow up in your portfolio, leaving you with huge losses should you sell on a sudden dip.

When it comes to the company's outlook, management acknowledged there will be "significant uncertainty," which investors are clearly not a fan of. Although issues appear to be baked in, shares could stand to rally over the medium term; however, I wouldn't feel comfortable recommending this stock due to the high degree of risk you'll take on for what I believe is just marginally higher reward.

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