2 Overvalued TSX Index Stocks That Could Plunge

Description

Many new investors desire to be successful value investors, just like Warren Buffett.

The art of finding undervalued securities is no easy task, however, and those beginners who draw too much emphasis on traditional valuation metrics like P/E ratios are at risk of getting burned by value traps — seemingly cheap stock that are actually expensive given the deteriorating fundamentals or long-term growth story.

Buying a stock *just* because it has a low P/E is often a recipe for disaster.

Stocks can be cheap for very good reasons, and there's no reason why a stock can't become even cheaper, as potentially falling earnings could turn a 10 P/E stock into a stock with no P/E at the drop of a hat.

Thus, it's vital to gain a full understanding of potential headwinds a company is facing before even thinking about picking up a name out of the **TSX** bargain bin.

This piece will have a look at two such stocks.

Magna International

Run a stock screener based on traditional valuation metrics and **Magna International** (TSX:MG)(NYSE:MGA) is likely to land near the top of the list.

The stock trades at an absurdly cheap 7.9 times forward earnings, 1.5 times book, and 0.45 times sales, all of which are lower than the firm's five-year historical average multiples of 9.1, 1.82, and 0.51, respectively.

Compared to other stocks, Magna looks like a steal. With a high margin of safety and such a rock-bottom multiple, it'd be hard to lose money on the name, right? Wrong.

Highly cyclical stocks like Magna should trade at a discount relative to other stocks because when the lights go out on the economy, these are the stocks that face the most downside. In essence, they could suffer “double damage” in a recession, as the demand for auto parts comes falling off a cliff.

Moreover, the auto-part makers like Magna are ridiculously capital-intensive, and once the inevitable bust phase of the auto cycle rolls around, auto part makers like Magna are positioned to fall off a cliff, making P/E ratios a pretty lousy metric of valuation, especially in the late stages of an economic cycle.

Relative to industry peers, Magna is an expensive stock. Add the recent **General Motors** strike and the continued rise of ridesharing services and you’ve got yourself a company with insurmountable headwinds, which could send the stock plunging much further.

Cineplex

Back in the summer of 2018, I warned investors about four headwinds that would send **Cineplex** (TSX:CGX) stock tumbling. At the time, the stock was near all-time highs, and all was well in the world of movies and popcorn.

Fast-forward just a few weeks later and Cineplex began a multi-year 58% peak-to-trough plunge. Cineplex stock is at 2010 lows, and the dividend yield has swollen past the 8% mark, opening up a value proposition for income-oriented investors.

With deep-pocketed video streaming platforms coming online this month, I see more pain in the forecast for Cineplex’s box office segment over the next year.

Fellow Fool Chris MacDonald believes that movie theatres are dead, and he’s sick of all the excuses that so-called pundits have to defend the industry that could go the way of drive-in movies.

Making such shallow excuses is dangerous for beginner income investors with confirmation bias hungry for that juicy 8% yield.

With a plethora of straight-to-stream options available from the comfort of one’s living room, why would one want to buy a $20 popcorn-and-soda combo in a theatre and have to put up with Tommy Texter and Sally Seat-kicker?

The economics have declined, and the original four headwinds I outlined when the stock was at all-time highs are continuing to mount. Even after the stock’s fall from grace, the name remains tremendously overvalued at 18.5 times trailing earnings given the baggage that investors may end up having to hold.

Sure, diversification efforts in entertainment and amusements has been picking up, but if that’s your only reason for owning the name, I’d sit on the sidelines and wait for a spin-off of that business, so you don’t need to risk your shirt in the dying business of movie theatres and popcorn, which will still account for a majority of revenues over the intermediate-term.

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