Value Investment or Value Trap?

When searching for undervalued stocks, it can be challenging to distinguish good value investments from “value traps.” A value trap is a company that appears to be trading at a discounted price relative to its earnings, sales, book value or other financial characteristics, but then its stock performs poorly as its financial performance deteriorates. We have some guidelines we follow to try to avoid value traps.

First of all, we tread carefully when analyzing companies whose industries are in long-term decline due to technological change. Eastman Kodak, the photographic film company, is a good example. Kodak declared bankruptcy in early 2012, but in the late 1990s, the stock market valued the company at over U.S. $30 billion. A decade ago, some prominent value investors were buying the shares on the way down, arguing that the company was undervalued due to the substantial cash flow from its film and patent licensing businesses. Eastman Kodak turned into a classic value trap, as the consumer transition to digital cameras eroded the film business faster than those investors expected. We could also mention companies like Blockbuster, the movie rental chain, or Yellow Media, the phone directories business, in this category.

Second, we know that a cyclical company can appear very cheap when its industry is at a cyclical peak and then become a value trap when the industry’s performance inevitably weakens. American homebuilding stocks had an amazing run from the early 2000s to the middle part of the decade. In early 2006, some value investors argued that the stocks were cheap based on their low price to earnings multiples. They were looking at the earnings these companies had for the previous twelve months, which were exceptionally high, due to the American housing bubble, and forgetting the cyclicality of the home building industry. In the years that followed, earnings plunged and, in many cases, turned negative. Investment returns were simply terrible for shareholders who bought back then. For example, even after a recent upsurge due to signs the U.S. homebuilding industry is recovering, a large homebuilder like PulteGroup Inc. (NYSE:PHM) trades in the mid-teens today versus over U.S. $40 per share in 2005 and 2006.

Third, we exercise caution when analyzing companies in commoditized industries that are facing competitors with lower production costs. Famous value investor Warren Buffett has called his 1960s investment in Berkshire Hathaway textile mills one of his worst investment decisions. The company

appeared to be undervalued when he invested, but emerging low-cost foreign textile production put consistent pressure on the prices of the company's key products. Buffett decided to close the mills in the 1980s. His current net worth of over U.S. $40 billion came from successful value investments in other industries. For a Canadian example, consider the forest products industry, which has set a few value traps for investors over the past decade. Canadian companies have been facing foreign competition from countries like Brazil, which has fast-growing trees and lower labour costs.

The North American food retailing industry is another good example. Shares of traditional grocery store chains have sagged over the past decade as efficient global giants like Wal-Mart Stores Inc. (NYSE:WMT) and Costco Wholesale Corp. (NASDAQ:COST) expanded their market share by discounting prices. Investors should always consider whether a company's customers will remain loyal in the face of price competition. The more commoditized the business, the more likely customers will switch to save money. Investors may want to avoid companies facing these issues, even when their stocks are cheap. We aim to purchase high quality companies for our clients at discounted valuations while avoiding value traps. The guidelines from this article are one component of our investment selection process.

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager

Andrey Schmidt *BA, LLB*
Investment Advisor

This article was first published in Sounding Board, the official monthly publication of The Vancouver Board of Trade. Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. Their clients may own securities mentioned in this column. The views of Michael Armstrong and Andrey Schmidt do not necessarily reflect those of CIBC World Markets Inc. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2015.