IFB230: How to Spot and Avoid Value Traps

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Dave

0:00

Alright, folks, welcome to Investing for Beginners podcast. Tonight we have episode 230. And we thought that given the current market conditions, it might be a good idea for us to revisit something we talked about in the past and kind of go over some ideas of some things that we are seeing in the market right now. So recording on May 12, 2022, the market currently is down around 18 to 90%, the s&p 500.

And things seem to be taking a turn for the worst as an overall market. And the thing we wanted to talk about is something called Value traps. And the reason why we want to talk about this is that as the market is falling, there appear to be lots and lots of companies that could be great potential investments, and some of them absolutely are going to be, but some of them may not be. And so, I think this would be a good idea for us to talk through some of the things that may help you avoid a value trap. And so with that, I'm going to turn it over to our friend, Andrew, and he's going to talk a little bit about value traps and kind of educate us on what those are. And then we could talk about some ways to avoid them.

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Andrew

1:11

Let's do that. There are lots of different types of value traps you can have; you did a great thread on Twitter about a company that looked like a good value but could be more of a value trap or let you describe that kind of situation. The one value trap I think that I want to focus on just from the beginning is the value trap of a company that's cheap because it's dangerous. And so this could be a company, and you would be surprised

where a company could be very healthy one year. And then the very next year, things become very unhealthy. So if you're a beginner and very easy way, it's a nice, hard, and fast rule.

And I know it's controversial, and there's lots of back and forth over whether you should go this way or not. But you can have a simple rule like if a company does not turn a profit if it has earnings, other negative for the year, you sell the company. And I've done that so far since I invested in 2012. And I have not regretted it. It hasn't always worked out; there have been companies that have done well since I sold on negative earnings, but I have not regretted it. So I did research on the biggest bankruptcies in the 20th century and 21st centuries. And that was actually the number one most observable common factor between these companies is they went they had negative earnings, and then they went bankrupt. Sometimes it was one year, sometimes it was three. But that's pretty much what happened. A good example, I think that really just screams out at me from some of that stuff, was Circuit City. And Circuit City was super interesting.

Because if you're not old enough to know what Circuit City was like, it was like I used to shop there. That's how old the company is. So it was like a Home Depot that's just kind of darker, right? Like a dark Home Depot without the lights and then just replace tools with computers. Yes, that place was cool. It was almost like I loved it. Yeah, it was awesome. It was almost like going into IKEA like an Ikea. Like, it's kind of exciting to go in there, see what you can find.

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Dave

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It was nerd heaven.

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Andrew

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There you go. So the thing was Circuit City grew very aggressively; they didn't leave enough of a margin of safety. And so what they ended up doing is they had a bunch of inventory. And when the recession hit, they were expected to sell that inventory. When that inventory did not sell, they were not able to cover their expenses. And so they went bankrupt; if you were to look at their financials, they had a year of negative earnings in the year before. And so that would have been an opportunity to get out before you know if it crashed 20% or whatever you get out, get out before it crashes to zero.

So it is possible that there are companies out there like that, and you have to be careful because these could be really cool companies that you really like that are growing that have earnings growth and all of those nice things. And you know, not to say negative earnings is a perfect metric, but it's a good one because it tells you a either their costs are really, really high or are they have these assets which used to produce profits, which they've determined, they're not gonna produce profits anymore. So they write them down, which creates a huge loss and makes negative earnings. Either of those two things is good. So it's a good thing to avoid and a good thing to kind of use as a hard and fast rule if you're a beginner.

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Dave

4:32

It is a great rule. And I think to kind of delineate or differentiate that idea. And we're not talking about companies that have just gone public and are producing negative earnings. Now, it's more about companies that have been profitable that all of a sudden start having negative earnings. That's kind of the differentiator.

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Andrew

4:52

Yeah, depending on, I guess, what your style of investment is, but yeah, for sure, I would definitely be more concerned if a company used to be profit Little no longer was,

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Dave

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right. Yeah, yeah, exactly. I think when you think about younger companies, one that kind of pops into my head is a company like CrowdStrike, which is a newer company and is growing really fast, but they've had negative earnings since they've gone public. And so that's not really necessarily what we're talking about; I think what Andrew was really referring to as more stable ish. Companies that all of a sudden have negative earnings that have a proven track record, and then all of a sudden you see something negative, that's like a red flag.

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And that kind of leads me into the company that I'm going to talk about. So on Twitter, I had a follower reach out to me and ask me; I tried to do weekly, deep dives into different companies every week. And I had somebody reach out to me and ask me to write about a company called Goodyear Tire. And I was like, Yeah, sure, why not, you know, I don't really know anything about the company. And it's not really in the field that I generally follow. But you know, I'm game to learn. And so when I first kind of digging into the company and started looking at it, the reason why this person was interested in it was that it was very optically cheap; it was trading around a four PE, or a four, price to earnings ratio of about four, which is really, really low.

And it also had a price to book, which is another kind of typical valuation relative metric that you can use, that can tell you how cheap it was, and it was trading for less than one. And so those are both indicators of a company that's trading, it's optically low, it looks really cheap. And so I thought, you know, hey, this could be, and you never know what you're going to come across until you start digging in, into the financials. And so when I kind of started digging into the company, a bunch of things just kind of started jumping out at me, kind of almost right away. And I think the first thing that really jumped out at me was the company has been experiencing a secular decline in revenues over the last 15 years, and particularly the last ten years. And so if you think about that, what that really means is that the company's revenues have slowed every year for the last 15 years. On a downward cycle, they may have an occasional bump, or does Okay, or whatnot. And that includes this past year, they had a bump and increased in revenues, which you know, is obviously good to

see. But when you see it for that long, that's a troubling sign. And it doesn't mean that the company is going bankrupt right away.

It does mean that the market is pricing this company cheaply. Because it's not worth much when a company is not growing its revenues, or at least staying in a steady state. And it's not doing better than the gross national product, or the GDP of the United States, for example, where they operate, that's never a good sign, it just means that the company is growing less than it could be, it could mean none of these things are definitive, these are just signs to look for to make you think and go hmm. So when you see the revenues drop by that much for that long period of time, it can lead you to think that the company's in the end stage of its lifecycle or that the products that they've been producing are just not as popular as they once were, for whatever reasons. So that's something that kind of just jumped out right away. When I was looking at the company, when I kind of started digging into that has also started noticing, for example, the operating margins.

So if you go farther down the income statement, we come to the operating margins, and that's basically the profit that the company makes from the cost that it comes to build a tire like oil, for example, as the cost of oil goes up their margins and decrease, because it comes more expensive for them to build the tires, that also includes the people to make the tires to sell the tires to run the stores that they operate, all those things go into the operations of the company. And good year actually has the lowest operating margins of its three big competitors, which are Bridgestone and Michelin. And they're almost half of what those other two competitors are. So again, that's not a great sign. So the other not-so-great sign is something that we just talked about the earnings so good your tires have had negative earnings in 2019 and 2020. So they are not a company that would strike you as a COVID impact big or small. So the fact that they were showing negative earnings prior to COVID was not a good sign, and then they only accelerated the following year. So two of the last three years, they've lost money. And that's not something you ever want to see, even for a company that's as optically cheap as Goodyear Tire is. So if we go farther down into the financials, then we start to see other things that really kind of set off the alarm bells.

And if you look at the balance sheet of the company, one of the things that really screams out at you like, oh my gosh, this is no good the company's debt. So all the debt that the company owes, people and investors and banks or whatnot, totals about around 6 billion dollars, and the company's market cap is around 3.8 billion. So they owe way more debt than the value of the company as a whole. That's never ever, ever, ever a good sign. That's actually quite bad. And so that's something that should really, really scare investors. You know, Android, I talk about some of these really big companies. I mean, can you imagine if Google or Microsoft, at 2.4 trillion, had that much debt on their balance sheet? Oh, my goodness, that's, that's insane. So the point is, is that when you start seeing some of these things, it's not necessarily a death knell for the company.

But when you start seeing stuff like that, that certainly sends off alarm bells. The other issue that you started seeing as well is you compare; they have all this debt, right. So they have all this debt, but they also have a lot of cash on the balance sheet because they've taken some of the debt that they've used to raise to put cash on the balance sheet. But they're also selling equity in the company; they're diluting. In other words, they're increasing the number of shares that they have on the balance sheet, which also impacts the price to earnings, as well. And so what they're doing is they're out there trying to generate all this cash, what little value the company has, from selling their shares, taking on debt, they also stopped paying their dividends.

So the dividend was they were a growing dividend-paying company up until 2020. And then it dropped off a cliff, and they stopped paying in 2021. So another, I guess, an alarm bell goes off, when they stopped doing that, either they're stopped paying a dividend, never ever, ever good sign, raise a whole lot of debt, and then dilute the company. In other words, they sell so much equity that they're reducing; they're increasing the

number of shares, which decreases the value that you and I have in the company. And so those are all things as shareholders we never want to see. Now good years are positioning all this as they're trying to move towards grading electric vehicle tires; I'll be the first to admit, I'm not a tired person; I'm not a car person. So take that for what it's worth. But that just sounds off.

Yeah, interesting off a little bit suspicious to me. So those are all things that just scream a value trap. No, I'm not saying that the company is gonna go bankrupt tomorrow. But they are also all reasons why there's no way in heck you would ever want to buy a company like this because it looks optically cheap. But then when you start looking at what's the real value of the business, there isn't any there negative free cash flow, which is where the value of the business really comes from negative earnings or close to negative earnings, stop paying a dividend, raising debt, those are all just screaming alarm bells, that this company is in trouble. And those are things that you want to stay away from.

So these are all signs of things that you can use to help you avoid value traps when you work for different companies that you see all of a sudden, hey, this is super cheap, all of a sudden, you know, maybe I should buy into this because this is the kind of company that they needed to really talk about. But that's why you need to look at the financials a little deeper and uncover some of those things.

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Andrew

13:07

It's almost like it's doing the opposite of everything we want to see. I mean, we want to see a company that's creating a profit, creating cash flows, and then giving those cash flows back to us. Not the other way around; the US is giving them the cash flow right in order to feed their money-burning machine. Right?

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Dave

13:25

Exactly. Yeah, exactly. I mean, if they stumble at all, they have no margin of safety. Because they've run up so much debt, they've basically used up any equity, they've had to try to generate that cash, and they're not generating free cash flow; they really have nowhere to turn other than trying to go back to the markets to try to take on more debt. But as the market cap keeps falling, nobody's gonna give them a loan, because why would they I mean, your chances of getting your money back just dropped dramatically in the circumstances like that. So it just screams value trap.

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Andrew

13:58

And those are the ones you want to be careful of. I mean, one of the common sayings is you don't want to try to catch a falling knife. And so if a company like this is cheap, and if it's down 50 60% off its highs if it's

trading at a P E of four, which makes it look four times cheaper than the rest of the market. You have to ask why? And if the answer to that question is because they're a cash-burning machine, you gotta run,

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Dave

14:25

you have to run because the cash that a company generates is really the lifeblood of the business. And if they aren't able to generate that cash for the business to operate, and do all the things that they need to grow, then eventually, they're going to run out of people that are going to be willing to give them money to continue the business, and it's going to go

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Andrew

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poof, what I find fascinating too, is the combination of all of those factors. You talked about the declining revenues for what was it like 15 years being just like down, down, down, down, so a product that's not in demand as much and then you can buy And that with some adversity in the market, and then the economy, and then combine that with the fact that now, it's like a doom loop where the struggles have forced them to take on debt, which forces more struggle? Yeah, it's tough. And that compounding can work both ways. I kind of learned the lesson of declining revenues the hard way, as you're well familiar with this story, but in my other company called Franklin resources, I had a pretty big position in that company. And my magical touch as soon as I bought the company, that our revenues just went down, year after year, after year. The Midas touch a few. Well, I thought

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Dave

15:41

it was just me, but apparently, it was both of us. A

Andrew

15:45

And you would be surprised at how the stock can kind of tread water for so long, even as revenues are declining. And so, at a certain point, you have to differentiate between a stock that stumbles because all businesses stumble versus one that's in a secular decline. And I think we don't use that term enough. But secular just basically means that this is a long-term trend instead of a short-term trend. So I'm also not a tire expert. I don't know what the story is with this company. But when it came to Franklin resources, they were hit really badly with the fact that there was this big move to passive, and the whole asset management business was changing. There were some of their peers who were positioned well for that, but they, in particular, we're not, they have a lot of like value investing active managers, and that's been crushed and

continues to get crushed. So ironically, this would be the year that it should all bounce back. But, you know, regardless, if it's a secular trend, you don't want to be in; eventually, you have to cut bait with the company and with the stock.

And so that's what I ended up doing. I didn't take a loss on it. But I certainly left money on the table because the s&p did way better than it did. And so that's something I think that is an easy one to also avoid if negative earnings are one to avoid declining revenues is another not just one year, two years, but secular decline for five years, just don't even think about a company like that, because it's telling you the demand for the company's product and services is decreasing every year.

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Dave

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And that's really hard to come back; it's really hard to come back from it, you think about some of these big companies that may be air quote, boring Johnson and Johnson, for example, you know, they're still able to grow their business, even though they've been around for quite a long time, they're still able to grow their revenues five to 10% a year in that range, because of the demand for their products. Plus, their market position allows them to have pricing power. So they can because there's a demand for their products, they can raise the prices on their products incrementally every year, which allows them to continue to grow. And something that we've talked about before, and I'll touch on it again, is kind of a lifecycle of a business. And when you think about a company like Johnson and Johnson, it may be definitely the more mature part of the business side. But it's still growing.

So a lot of times, what Andrew was talking about with, like the revenue declines, is sometimes that's just a symptom of the business is either in an industry that is going through changes, and the company may be got caught flat-footed and isn't moving with those changes. Or it could be that the product that they created or that has been driving their revenues for all these years has faced competition; Jeff Bezos laser always likes to say your margin is my opportunity and disruptors. And innovation is the name of the game today. And you see it move quicker now with internet companies, SAS companies, and all those things much faster than it used to with more physical products, obviously, but the same idea applies is that you have to think about what the company makes, what products or services they offer, and whether they're still viable now, and where they're going to be viable in down the road.

And if the company's going through changes in the revenues are declining for a long period of time. It may not be a death knell immediately, but it will be eventually. And you know, not every company stays around forever. I think the average time in the s&p 500 is less than five years. Ten years. It's it's I

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Andrew

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think it's around 15. But is it okay? It gets dragged down because a lot of companies get bought up to so true. It isn't a deceiving statistic. Yeah,

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Dave

19:33

true. But I think you know, the when you think about the lifecycle, I want to try to think about it doesn't have to go into in-depth analysis. But I think you can fairly quickly figure out how relevant the company is just by looking at the revenues and seeing how those have evolved over a longer period of time and if they stayed flat or went down, then that could not be the greatest indication. And if they're going up, even if they're only going up 234 percent, those are still an indication that the company has something going on with it, depending on what it is that they do.

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Andrew

20:04

Yeah, definitely does kind of just go back to what we try to talk about a lot with the moat. If a company has a moat, if it has something that makes it different, that it can defend its profits, whether it's the best, it's number one, it's the biggest, or it just is different in a way that it serves its particular customers in its niche, better than even the big fish can that when that moat is there, then you get that pricing power, then you get that ability to continually grow without having to grow in size, you can just grow through pricing power. And I think that's one of those things. I know Buffett has touched on it quite a bit, but I think it kind of goes in this like go go go kind of growth, growth, growth-focused market; I think a lot of that pricing power goes unnoticed until you zoom out 20 years later, and you're like, oh, wow, that company does have pricing power.

Right? Yeah. But it's a great way to differentiate between value traps; it's a good question to ask because this company's revenues might be down one year, two years, it's a recession, whatever it is. But if they do have that pricing power, you can feel confident; I'm gonna buy more because I know any struggles are having are temporary; eventually, over the long term, they're gonna be able to continue raising their prices that are going to give growth for the future.

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Dave

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Yeah, exactly. And it's an easy question to ask yourself. And it's also an easy question. In some cases, it's an easy question to kind of answer, or at least think about, and there was lots and lots of conversation about Netflix, whether they had pricing power to raise their subscription rates, and they eventually did, and it didn't seem to affect them that much. And then COVID hit, and then kind of everything got thrown into disarray. But that's one of the questions. It's kind of hanging out there about Disney, you know, Disney plus is whether they have pricing power with that segment of their business. And kind of the same thing applies with YouTube TV, with Hulu, any of those kinds of businesses there. It's an easy question, you know, would you pay more for HBO plus or not?

And if you can, and you think other people will, then that's probably a good answer. And if you're not sure, then that's not a bad answer, either. And so I think there are lots of things when you think about a moat or the pricing power of a business, it's easy to ask yourself those questions, you know, would I be willing to pay more for my Starbucks coffee? And if the answer is yes, then obviously, they have pricing power, at least with you. And chances are with a lot of other people. So you know, I know that that's kind of a cult following with their coffee. But it just goes to show that there are lots of different ways for businesses to grow. And there are lots of ways for businesses to evolve. And you have to kind of think about how those can impact your investment and whether those are going to continue. And if you see those things starting to stop, kind of like Andrew was talking about with Franklin resources. You know, when he got invested in the business, it was a great business. And it was one of the market leaders in what it is that they did. But like Andrew said, the kind of how people invested kind of started to shift. And it sounded like Franklin was kind of late to the game to change. And they weren't positioned to handle that.

And it caused him to struggle. And those are kinds of things that when you're kind of analyzing companies, those are some of them, I guess, soft skills of thinking about how a business is going to react to things. And again, it all comes back to the fact that we're buying businesses; we're not buying tickers on a computer screen. We're actually business; we're becoming owners of that business. And we have to think about whether that's a business we want to be involved in. And these are all great questions to ask yourself as the market continues to tumble. And who knows what's going to happen tomorrow. Andrew and I are not prognosticators. And I can't tell you what it's going to do tomorrow. And I certainly can't tell you what it's going to do two weeks from now. It could go straight back up tomorrow.

Nobody knows. And if it does, awesome. If it doesn't, okay, we'll deal with that too. But those are just, you know, as companies more and more companies become optically cheaper, please ask yourself these questions to try to avoid catching those falling knives or getting invested in companies just because they're cheap. Sometimes, you know, the market is efficient, but sometimes it isn't. And that's where we get the opportunities to buy these great companies at discounts. But the flip side of that is sometimes they punish companies for a reason. And they are being punished because they are not a good investment. And so that you have to take that into consideration as well.

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Andrew

24:29

That's very well said.

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Dave

24:30

Anything else to add?

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Andrew

24:31

That's perfect.

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Dave

24:32

Okay. All right. Well, with that, everyone, we are going to wrap up our discussion on value traps. Tonight. We hope you guys got some good takeaways from all that information. And if there was anything that we talked about today that you are a little bit confused about, don't quite understand, don't know what a price to earnings is. Don't know what the price to book is. How do I read an income statement?

There are lots and lots of great resources on our website, e investing for beginners.com; we have a great search bar there, so you can just simply type that in your Income Statement, and you're gonna see a whole bunch of articles that can help explain all that to you. So there's lots of great research there for Andrew, and I've written a lot about a lot of these things to try to help everybody learn. And there so there are lots of great resources there for you. So without any further ado, I will go ahead and sign us off; you guys go out there and invest with a margin of safety. Emphasis on the safety. Have a great week. We'll talk to you all next week.