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Value Trap

What is a 'Value Trap'

A value trap is a stock that appears to be cheap because the stock has been trading at low multiples of earnings, cash flow or book value for an extended time period. Stock traps attract investors who are looking for a bargain because these stocks are inexpensive. The trap springs when investors buy into the company at low prices and the stock never improves. Trading that occurs at low multiples of earnings, cash flow or book value for long periods of time might indicate that the company or the entire sector is in trouble, and that stock prices may not move higher.

BREAKING DOWN 'Value Trap'

Companies, and even sectors, can be doomed, because of situations such as the inability to survive competition, the inability to generate substantial and consistent profits, the lack of new products or earnings growth, or ineffective management. Often, a value trap appears to be such a good deal that investors become confused when the stock fails to perform. As with any investment decision, thorough research and evaluation is recommended before investing in any company that appears cheap when reviewing its relevant performance metrics.

Liquidity Trap

The liquidity trap is the situation in which prevailing interest rates are low and savings rates are high, making monetary policy ineffective. In

a liquidity trap, consumers choose to avoid bonds and keep their funds in savings, because of the prevailing belief that interest rates will soon rise. Because bonds have an inverse relationship to interest rates, many consumers do not want to hold an asset with a price that is expected to decline.

BREAKING DOWN 'Liquidity Trap'

Should the regulatory committee try to stimulate the economy by increasing the money supply, there would be no effect on interest rates, as people do not need to be encouraged to hold additional cash.
As part of the liquidity trap, consumers continue to hold funds in standard deposit accounts, such as savings and checking accounts, instead of in other investment options, even when the central banking system attempts to stimulate the economy through the injection of additional funds. These consumer actions, often spurred by the belief of a negative economic event on the horizon, causes monetary policy to be generally ineffective.

Signs of the Liquidity Trap

One marker of a liquidity trap is particularly low interest rates. These low interest rates can affect bondholder behavior, along with other concerns regarding the current financial state of the nation, resulting in the selling of bonds in a way that is harmful to the economy. Further, additions made to the money supply fail to result in price level changes, as consumer behavior leans toward saving funds into lower-risk and highly liquid mechanisms. Without changes to interest rates, consumers are not motivated to invest into other options.

Low interest rates alone do not define a liquidity trap. For the situation to qualify, there has to be a lack of bondholders wishing to keep their bonds, and a limited supply of investors looking to purchase them. Instead, the investors are prioritizing strict cash savings over bond purchasing. If investors are still interested in holding or purchasing bonds at times when interest rates are low, even approaching the zero limit, the situation does not qualify as a liquidity trap.

Lenders and Borrowers

A notable issue of a liquidity trap involves financial institutions having problems finding qualified borrowers at a particular level. This is compounded by the fact that, with interest rates approaching zero, there is little room for additional incentive to attract well-qualified candidates. This lack of borrowers often reflects lower buying behavior, such as that related to higher priced, and often financed, purchases such as cars and homes.

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Sunk Cost Trap

The tendency of people to irrationally follow through on an activity that is not meeting their expectations because of the time and/or money they have already spent on it. The sunk cost trap explains why people finish movies they aren't enjoying, finish meals that taste bad, hold on to investments that are underperforming and keep clothes in their closet that they've never worn. The sunk cost trap is also called the Concorde fallacy after the failed supersonic Concorde jet program that funding governments insisted on completing despite the jet's poor outlook.

BREAKING DOWN 'Sunk Cost Trap'

Individuals, businesses and governments fall into the sunk cost trap when they base their decisions on past behavior and a desire to not waste the time or money they have already spent, instead of cutting their losses and making the decision that would give them the best outcome going forward. People are reluctant to admit, even to themselves, that they have wasted resources on a past decision. Changing directions is viewed, perhaps only subconsciously, as admitting failure. As a result, people tend to stay the course or even invest additional resources in a bad decision in a futile attempt to make their initial decision seem worthwhile.

Here is an example of the sunk cost trap in action:

Jennifer buys $1,000 worth of Company X's stock in January. In December, its value has dropped to $100 even though the overall market and similar stocks have risen in value over the year. Instead of selling the stock and putting that $100 into a different stock that is likely to rise in value, she holds on to Company X's stock, which in the coming months becomes worthless.

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Price to Free Cash Flow

Video Definition

Price to free cash flow is an equity valuation metric used to compare a company's per share market price to its per share amount of free cash flow. This metric is very similar to the valuation metric of price to cash flow, but is considered a more exact measure due to the fact that it uses free cash flow, which subtracts capital expenditures (CAPEX) from a company's total operating cash flow, thereby reflecting the actual cash flow available to fund non-asset-related growth. Companies use this metric when they need to expand their asset bases either in order to grow their business or simply to maintain acceptable levels of free cash flow.

$$\text{Price to FCF} = \frac{\text{Market Capitalization}}{\text{Free Cash Flow}}$$

BREAKING DOWN 'Price to Free Cash Flow'

A company's free cash flow is important because it is a basic indicator of the company's ability to generate additional revenues, which is a crucial element in stock pricing.

The price to free cash flow metric is calculated as follows:

Price to free cash flow = market capitalization value / total free cash flow amount

For example, a company with $100 million in total operating cash flow and $50 million in capital expenditures has a free cash flow total of $50 million. If the company's market cap value is $1 billion, then the company's stock trades at 20 times free cash flow - $1 billion / $50 million.

How Investors Use the Price to Free Cash Flow Metric

Highest P/FCF Stocks in the S&P 500	
Add	Symbol
	PSA
	CSX
	CNP

Lowest P/FCF Stocks in the S&P 500	
Add	Symbol
	RE
	SYF
	COF

As price to free cash flow is a value metric, lower numbers generally indicate a company that is undervalued and whose stock is relatively cheap in relation to its free cash flow. Conversely, higher price to free cash flow numbers may indicate that the company's stock is relatively overvalued in relation to its free cash flow. Therefore, value investors favor companies with low or decreasing price to free cash flow values that indicate high or increasing free cash flow totals and relatively low stock

share prices. They tend to avoid companies with high price to free cash flow values that indicate the company's share price is relatively high compared to its free cash flow. In short, the lower the price to free cash flow, the more a company's stock is considered to be a better bargain or value.

As with any equity evaluation metric, it is most useful to compare a company's price to free cash ratio to that of other similar companies in the same industry. However, the price to free cash flow metric can also be viewed over a long-term time frame to see if the company's cash flow to share price value is generally improving or worsening.

Price to free cash flow ratio can be affected by companies manipulating the statement of their free cash flow on financial statements, by doing things such as preserving cash by putting off inventory purchases until after the period covered by the financial statement.

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Book Value

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Video Definition

Book value of an asset is the value at which the asset is carried on a balance sheet and calculated by taking the cost of an asset minus the accumulated depreciation. Book value is also the net asset value of a company, calculated as total assets minus intangible assets (patents, goodwill) and liabilities. For the initial outlay of an investment, book value may be net or gross of expenses such as trading costs, sales taxes, service charges and so on.

BREAKING DOWN 'Book Value'

Book value is also known as "net book value (NBV)" and, in the U.K., "net asset value."
As the accounting value of a firm, book value has two main uses:

1. It serves as the total value of the company's assets that shareholders would theoretically receive if a company were liquidated.

2. When compared to the company's market value, book value can indicate whether a stock is under- or overpriced.

In personal finance, the book value of an investment is the price paid for a security or debt investment. When a stock is sold, the selling price less the book value is the capital gain (or loss) from the investment.

For more information, check out Digging Into Book Value

Historical Cost

The term book value derives from the accounting practice of recording asset value at the original historical cost in the books. While the book value of an asset may stay the same over time by accounting measurements, the book value of a company collectively can grow from the accumulation of earnings, generated through asset use. Since a company's book value represents the shareholding worth, comparing book value with market value of the shares can serve as an effective valuation technique when trying to decide whether shares are fairly priced.

Mark-to-Market Valuation

There are limitations to how accurately book value can be a proxy to the shares' market worth when mark-to-market valuation is not applied to assets that may experience increases or decreases of their market values over time. For example, real estate owned by a company may gain in market value at times, while its old machinery can lose value in the market because of technological advancements. In these instances, book value at the historical cost would distort an asset or a company's true value, given what is actually priced in the market.

Price-to-Book Ratio

Price-to-book (P/B) ratio as a valuation multiple is useful for value comparison between similar companies within the same industry when they follow a uniform accounting method for asset valuation. The ratio may not serve as a valid valuation basis when comparing companies from different sectors and industries whereby some companies may record their assets at historical costs and others mark their assets to market. As a result, a high P/B ratio would not be necessarily a premium valuation, and conversely, a low P/B ratio would not be automatically be a discount valuation.

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Multiple

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A multiple measures some aspect of a company's financial well-being, determined by dividing one metric by another metric. The metric in the numerator is typically larger than the one in the denominator.

For example, a multiple can be used to show how much investors are willing to pay per dollar of earnings, as computed by the price-to-earnings (P/E) ratio. Assume you are analyzing a stock with $2 of earnings per share (EPS) that is trading at $20. This stock has a P/E ratio of 10. This means investors are willing to pay a multiple of 10 times the current EPS for the stock.

Calculated as:

$$\text{Multiple} = \frac{\text{Performance Metric "A"}}{\text{Performance Metric "B"}}$$

BREAKING DOWN 'Multiple'

In the world of stock valuation, there are two different valuation methods: one is based on cash flow, and the other is based on a multiple of some performance measure, such as the earnings or sales. Valuation based on

cash flow is considered to be an intrinsic valuation, and valuation based on a multiple is considered to be relative, because the multiple is relative to some performance measure.

Commonly Used Multiples

The most common multiple used in the valuation of stocks is the P/E multiple. It is used to compare a company's market value with its earnings. A company with a price or market value that is high compared to its level of earnings has a high P/E multiple. A company with a low price compared to its level of earnings has a low P/E multiple. A P/E of 5x means a company's stock is trading at a multiple of five times its earnings. A P/E of 10x means a company is trading at a multiple that is equal to 10 times earnings. A company with a high P/E is considered to be overvalued. Likewise, a company with a low P/E is considered to be undervalued.

Other commonly used multiples include the enterprise value (EV) to earnings before interest, taxes, depreciation and amortization (EBITDA) multiple, also referred to EV/EBITDA. It is used to measure the cash flow available to the firm. EV to earnings before interest and taxes (EBIT), also referred to as EV/EBIT, is used for less capital-intensive companies with a small depreciation and amortization expense. The EV to sales ratio, also referred to as EV/Sales, is a multiple that companies with negative earnings often use. All multiples act as a single number that analysts can multiply by some financial metric to determine the relative value.

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Cash Value Added - CVA

A measure of the amount of cash generated by a company through its operations. It is computed by subtracting the 'operating cash flow demand' from the 'operating cash flow' from the cash flow statement.

BREAKING DOWN 'Cash Value Added - CVA'

Cash value added is similar to economic value added but takes into consideration only cash generation as a opposed to economic wealth generation. This measure helps give investors an idea of the ability of a company to generate cash from one period to another. Generally speaking, the higher the CVA the better it is for the company and for investors.

Cheap Money

A loan or credit with a low interest rate, or the setting of low interest rates by a central bank like the Federal Reserve. Cheap money is good for borrowers, but bad for investors, who will see the same low interest rates on investments like savings accounts, money market funds, CDs and bonds. Cheap money can have detrimental economic consequences as borrowers take on excessive leverage.

BREAKING DOWN 'Cheap Money'

When money is cheap, it is a good time for borrowers to take on new debt or consolidate existing debts. However, borrowing more than one can afford to repay was one of the primary catalysts of the 2008 recession.

Here are a few examples of cheap money:

-A credit card with a 0% introductory APR for 12 months

-A 30-year fixed-rate mortgage at 4% interest

-An auto loan at 0.5% interest

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Operating Cash Flow Ratio

Video Definition

The operating cash flow ratio is a measure of how well current liabilities are covered by the cash flow generated from a company's operations. The operating cash flow ratio can gauge a company's liquidity in the short term. Using cash flow as opposed to income is considered a cleaner, or more accurate, measure since earnings can be manipulated.

$$\text{OCF Ratio} = \frac{\text{Cash Flow from Operations}}{\text{Current Liabilities}}$$

BREAKING DOWN 'Operating Cash Flow Ratio'

There are essentially two worlds in fundamental investment analysis; one is based on cash, and the other is based on earnings. Good fundamental analysts use both when researching the value of an investment.

Cash Flow From Operations

Earnings are derived from revenues. A company generates revenue, and then has to pay suppliers for the cost of goods sold and other expenses related to operations. It sounds simple, but there are many accounting conventions used to match revenues and expenses in the period they are incurred. It is a system referred to as accrual accounting. As a result,

earnings may differ greatly from the actual cash flow of a company, and analysts like to use cash flow from operations as a cleaner proxy for profit than earnings or net income.

The Calculation and Interpretation

The operating cash flow ratio is calculated by dividing cash flow from operations (CFO) by current liabilities. Current liabilities are the portion of liabilities due within one year and can be found on the balance sheet. The operating cash flow ratio is a measure of the number of times a company can pay off current debts with cash generated in the same time period. A higher number means a company can cover its current debts more times, which is a good thing. Companies with a high or increasing operating cash flow ratio are in good financial health. Those that are struggling to cover liabilities may be in trouble, at least in the short term.

Manipulation

Companies can also manipulate cash flow from operations; it is important to be mindful of a few accounting conventions. Some companies deduct depreciation expense from revenue even though it does not represent a real outflow of cash. Depreciation expense is an accounting convention which is meant to write off the value of assets over time, but it is not real cash. As a result, companies add depreciation back to cash in cash flow from operations.

Another way companies can manipulate cash flow is by paying bills later. If companies pay bills later, they can extend payables and the cash they have on hand. Likewise, if companies adopt looser credit policies, they may increase revenue and accounts receivable, which decreases cash. It may seem counter-intuitive that a company can grow revenues and show a decrease in operating cash flow, but this is how it happens and savvy analysts know where to look to find it.