

Buyer Beware: How to Avoid the ‘Value Trap’ Stocks That Can Kill Your Portfolio

Just about everything you read about investing – anything you watch – has one focus: making money.

It’s an obsession.

It’s also only part of the investing equation.

Whether we’re talking stocks or options, cryptos or currencies, if you really want to win, to make money, to amass wealth, you also have to avoid losses.

That’s talked about much less frequently.

But it’s crucial.

I often show you in these columns how to screen for high-quality, potentially winning stocks using *TradeSmith* tools like our **Business Quality Score (BQS)**, **Ideas Lab** strategies, and filters that allow us to find quality stocks with the highest free-cash flow to enterprise value (FCF/EV).

These are excellent starting points to zero in on stocks with a winning upside.

Today I’m going to walk the walk: I’m going to show you how to avoid losers.

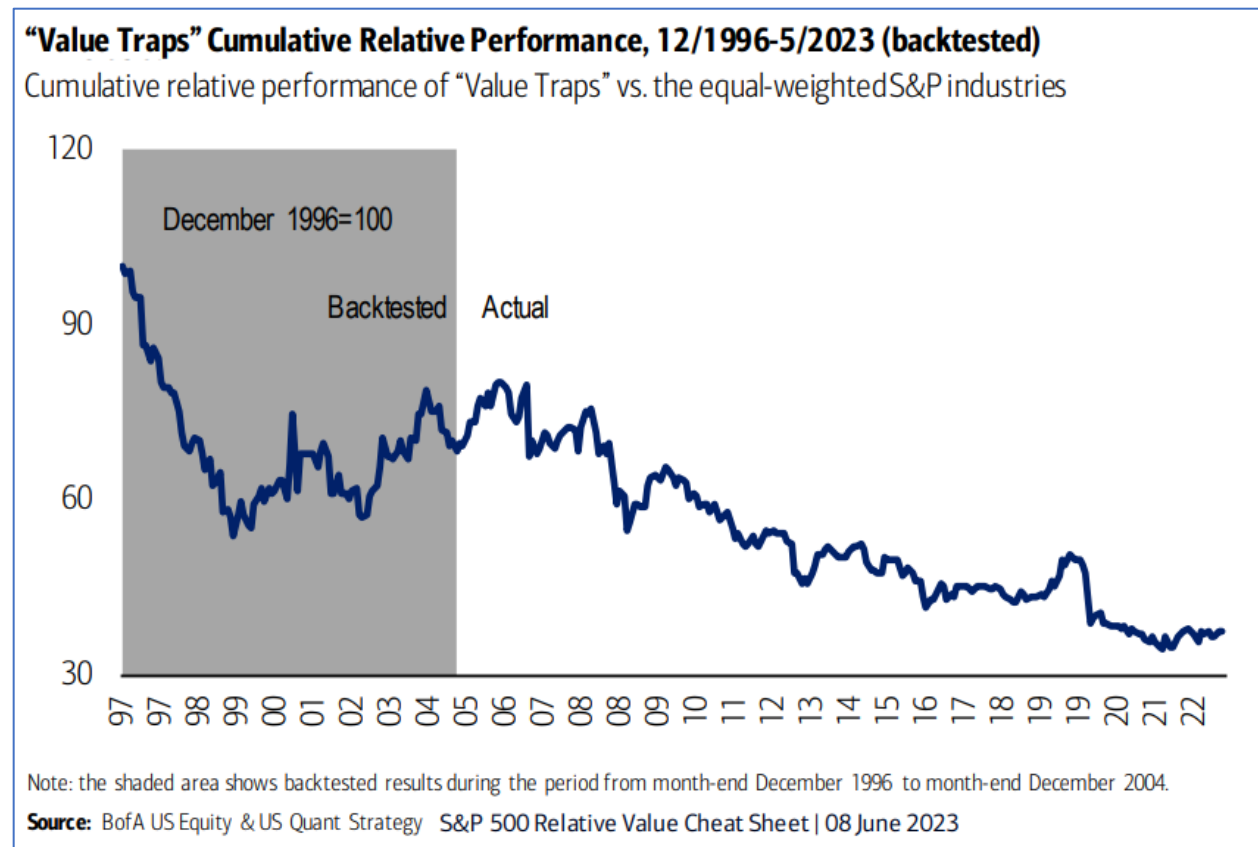
Trouble is, lots of stocks can look and feel like winners.

But, as the old saying goes, looks can be deceiving.

Especially the stocks I refer to as “value traps.”

Stocks like these can punch a big hole in your portfolio and cause your future to founder.

So you have to avoid them at all costs.



This **Bank of America** chart illustrates the cumulative performance of “value trap” stocks that company researchers have tracked since 1997.

Since 2005, they’ve collectively lost about 40% of their value – while the equal-weighted **S&P 500 Index** has gained 277% during the same time frame. But how can you tell the difference between a value-trap play you must avoid, and a plain old “value” play that’s cheap and probably represents a good moneymaking opportunity?

Just as there’s no consensus definition for a “quality stock,” there’s also no universal set of guidelines that identify a “value trap.”

Typically, we’re talking about stocks that appear cheap due to low price-to-earnings (P/E) or low price-to-book-value (P/BV) ratios. But some stocks are cheap for a reason – they’re garbage.

First, these companies may have inconsistent operating results, or their businesses may be in long-term decline (like a buggy-whip company operating when the mass-produced Model T Ford made its debut).

Second, exciting new stocks may look cheap on some metrics, like P/BV – but have little or no profits.

Third, stocks with fast revenue growth – but little or no cash flow – are likewise big red-flag plays with value-trap potential.

When it comes to evaluating stocks one by one, there is no substitute for doing your homework. Download the latest annual report from the company website and start digging.

Better yet, simply log in to your *TradeSmith Finance* account and take a closer look. Look up any stock you want using **Search for Ticker**, then navigate to the **Financials** tab. At the **Type** drop-down menu, select “Fundamentals.” You’ll find several years’ worth of summarized results pulled from the Income, Balance Sheet, and Cash Flow statements.

Pay close attention to whether sales growth and profit growth are consistent over the years. Also be sure growth in sales and profit is accompanied by growth in cash flow, too. If not, watch out.

When it comes to finding potential value traps, *TradeSmith* members can use our powerful Screener tool to weed out the portfolio wreckers.

Here’s a quick and easy screen I put together in *TradeSmith Finance*. Note that you must have access to our Screener tool (under the **Invest** menu) via *Ideas by TradeSmith*, *Trade360*, or a Platinum membership, and our BQS tool via *Ratings by TradeSmith* or Platinum.

Let me walk you through it.

As always, be sure you are logged in to the *TradeSmith Finance* platform.

Click the “+ Create New Screener” button and set up the following:

Health Status: The biggest hidden danger posed by value-trap stocks is that they appear healthy on the surface – while their financials may be rotting underneath. Start by screening for U.S. stocks in the Green Zone.

Market Capitalization: Value traps could be lurking in any size stock, but I limited the screen to mega-cap, large-cap, and mid-cap stocks because most investors gravitate to them. You can choose any market-cap limits.

P/B: Screen for stocks with low price-to-book (P/B) ratios that appear to be healthy and cheap, at least at first glance. The average P/B ratio for S&P 500 stocks is about 4x right now. So I’m looking for more undervalued stocks (between 1 and 4) that may in fact be cheap for a good reason.

Free Cash Flow: Then add a filter to screen for stocks with negative FCF (less than \$0). That helps you uncover companies that may have decent growth and profits, but aren’t generating real cash after their operating and investment expenses get paid.

Business Quality Score: Finally, I want to double-check that these stocks are poor quality by using our BQS to screen for stocks in the bottom half of our quality rankings (less than 50).

+ Manage Filters

Health Status  ▶ Green Zone ● Yellow Zone ■ Red Zone

Asset Type ✕ Stock

Country of Exchange ✕ United States

Market Capitalization ☐ Nano Cap ☐ Micro Cap ☐ Small Cap ☐ Mid Cap ☐ Large Cap ☒ Mega Cap

P/B  between 1 and 4

Free Cash Flow  less than \$0

Business Quality Score more than 50

Display & Sort Results Show top 250 Sort results by Health ASC

Save As New Save Changes Run Screener

[Saved Screeners](#) (1 result)  

☐	Ticker	Rating	Health 	VQ%	Avg VQ%	VQ Ratio 	Newsletters	Billionaires
☐	JPM JPMorgan Chase	Bullish	▶ 10m+	20.09%	26.22%	-23.39%	5	3

When I ran this screen, I got a single result: JPMorgan Chase.

Now, please understand that just because this stock made my value-trap list doesn't necessarily mean it's a bad company or a poor investment. But if you own this stock, or are considering buying it, you better do some more homework first.

Mike Burnick's Bottom Line: Value-trap stocks consistently underperform the stock market – and by a very wide margin. That's because many appear to be bargains but then turn out to be undervalued for very good reasons. Caveat emptor – let the buyer beware!

Don't forget, you can send any questions or comments to our dedicated [email right here](#).

While I can't reply personally to everyone, I will respond to shared questions in another issue soon.

Good investing,

Mike Burnick

Senior Analyst, TradeSmith