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Stock Strategist

Five Stocks That Look Like Value Traps

by Mark A. Sellers | 01-22-03 | 06:00 AM

Regular readers of [Morningstar.com](#) are familiar with our preference for stocks with wide **economic moats**. Wide-moat companies tend to be leaders in attractive sectors like health care and business services, and generate returns on invested capital well above those of the average company.

If there's a problem with these types of companies, though, it's that their stocks rarely become discounted enough to show up in the bargain bin. For example, in *[Morningstar StockInvestor](#)*, our monthly newsletter, we publish a watch list of 50 such companies each month. These companies have wide moats, but the average trailing P/E ratio of the stocks on the list is about 34, compared with 29 for the S&P 500--not astronomically expensive, but not exactly dirt-cheap, either.

At the other end of the spectrum are what Warren Buffett calls "cigar-butt" stocks. These stocks are so beaten down, it's hard to resist picking them up off the ground and trying to get one last puff out of them before throwing them away. After all, even if they only have one puff left, the price is really cheap.

But investing in beaten-down stocks sometimes means getting stuck in what's called a "value trap." A value trap is a conundrum familiar to experienced value investors. It happens like this: You buy a stock that's really cheap. Maybe the stock pays a nice dividend. Over the next few years, however, the stock slowly gets even cheaper as new problems emerge. Often, there are problems with the company's accounting, and the stock becomes (seemingly) irrationally cheap. The stock always seems too cheap to sell, so you hold onto it waiting for management to turn the company around. But it doesn't happen. In fact, one at a time, new problems at the company appear--problems you didn't anticipate when you first purchased the stock. Then one day you wake up and realize you've lost a lot of money on the stock and there's no turnaround in sight. And then it hits you: The company's business model is broken.

You've been snared by a value trap.

Below are five stocks that look like value traps to me, despite their

seemingly cheap price tags. In next week's column, I'll list five more.

Five Possible Value Traps

	Morningstar Star Rating	Fair Value (\$)	Current Price (\$)	Economic Moat	Risk Rating
General Electric <u>GE</u>	★★★	28.00	24.06	Narrow	Medium
Tyco International <u>TYC</u>	★★★	25.00	17.11	None	High
Motorola <u>MOT</u>	★★	9.00	8.75	None	Medium
Interpublic Group <u>IPG</u>	★★★	16.00	13.41	Narrow	Medium
Electronic Data Systems <u>EDS</u>	★★	20.00	16.95	Narrow	High

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Data as of 01-21-03.

► General Electric GE

We've been panning this stock for almost two years in *StockInvestor*, and I see no reason to change course on the stock now. GE's complexity makes it incredibly hard to know what's really going on inside all those divisions. And intuitively, the economics of the company seem average, at best--most of GE's businesses are commodity-oriented. That's why we don't rate the company's economic moat as wide, despite its "smooth" earnings history. I'd say the stock is about fairly valued right now assuming the company's problems are mostly related to a sagging economy. But if it turns out there are more serious issues inside GE, there's no compelling reason why the stock couldn't get a lot cheaper.

► Tyco International TYC

Who knows what's hiding inside Tyco's books? I'm a big believer in the "cockroach theory" as it applies to companies with problems. If you see one cockroach, you probably have a lot more living in the walls. In Tyco's case, I'm worried that the accounting issues that have come to light will continue to shine brightly. Granted, there are a lot of smart investors who have bought Tyco's stock in recent months, including Bill Miller and the team at Clipper Fund CFIMX, but my inclination would be to avoid it at any price for the next couple of years. Even though the company's old management team (which created the problems in the first place) has largely been replaced, I'm not convinced the problems are fixed.

► Motorola MOT

The quality of Motorola's earnings is poor. The excessive use of pro forma accounting and numerous "one-time" charges bothers me. Until the company cleans up its accounting practices, I'd avoid it at any almost any price.

► Interpublic Group IPG

This company's problems keep getting worse. A year ago, it looked

like a good play on an economic rebound; after all, Interpublic is the largest ad agency in the world. But in August, accounting concerns sent the stock crashing 25% as the company announced it would delay its earnings release to "accommodate" its audit committee.

Ultimately, Interpublic announced that previous financials would have to be restated, then later raised the amount of the restatement by more than \$100 million. Oops. A formal SEC investigation is now under way. A perfect example of the cockroach theory.

► **Electronic Data Systems EDS**

Although the firm's long-term outsourcing contracts generate predictable and recurring revenue, we no longer consider EDS a safe haven among technology stocks. Percentage-of-completion accounting, which EDS uses to account for some contracts, provides great discretion as to when revenue is recognized. This makes it easy for the company to "manage" its earnings.

EDS grew in booming times by signing contracts with the companies that have since blown up, including the now-bankrupt UAL UAL, WorldCom WCOEQ and US Airways UAWGQ. Buyers of EDS today are assuming that exposure to additional risky deals is limited and cash flow will improve when startup costs on large contracts decline. However, neither is a foregone conclusion. EDS has other risky contracts with airlines and troubled firms like American Air AMR and Xerox XRX. I'd avoid the shares at any price until accounting concerns and an SEC investigation are fully resolved.

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