The Paradox of the Value Trap

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Active Value is Challenged

- The passive challenge
  - Fees
  - It’s the benchmark
  - Intellectual dominance in public securities
  - Performance since the GFC
  - Tax efficiency issues

Most market activity is driven by non-fundamental factors

Is Value going from a “stopped clock” to a “stopped calendar”?

Defining “Value Trap(s)”

- Value returns= (economic returns of asset+net valuation change)
- A Laffer Curve issue of disaggregated asset returns.
  - In practice   positive valuation change vital
    - Publicity
    - Activism
    - Public/private arbitrage

Value stocks that just don’t go up are NOT inherently value traps

Value Trap as Cop-Out

- “Our value approach avoids value traps.”
- “I am not a run of the mill value manager and do not get stuck in value traps.”
- “Most of our ideas worked ; but X and Y proved to be value traps and dragged down our performance .”

Value Trap is Usually Value Defective

- Enterprise value vs market cap
- Debt issues
- High and continuing capital needs
- Limited and/or highly variable cash flow
- Deferred off-balance sheet liabilities or costs
- Contingent legal liabilities
- Contingent political risks
- Finite management resources and distraction
- Adverse personnel selection

Value Traps Often Undervalue Important Contingencies

- Contracting network and/or scale effects
- Cost of capital risks from insufficient internal funding
- Price risks in commodity industries
- Known secular challenges

Traps

- For existing investors:
  - Often alluring current earnings and/or dividends
  - Deferred tax wedge
  - Hope of takeover take-out or counter-trend rally
  - External identification with the name/illiquidity

  For New investors:

  -Apparently cheap

  -Asymmetric optimism

  -Often multiple vulnerabilities

  -Nature sides with the hidden flaw

Wheat or Chaff?

- Valuation metrics always matter
- Defects compound
- Too many structural risks precludes “value”
- Still could be a good speculation. Different framework.
- Asymptotic returns are very important
- Potential perma-cheaps must be robust businesses
- Can be attractive investment approach e.g. community banks

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