PERKINS®
INVESTMENT MANAGEMENT

BEWARE: VALUE TRAPS LURKING

WHAT TO LOOK FOR AND HOW TO NAVIGATE POTENTIAL PITFALLS

UNCOMMON VALUE℠

value trap (val•ue trap | \'val-(.)yü 'trap\) noun

A stock which has fallen out of favor and appears cheap, but will nonetheless underperform the market over time.

Value-oriented investors are rightly attracted to stocks that have sold off significantly from their highs, are in the press for all the wrong reasons, and appear alluring on a variety of valuation metrics. The purchase of a low-valuation stock, especially when sold by a frustrated seller, may provide the buyer a measure of downside protection and, should operating results and valuations turn higher, significant upside potential as well.

Value investing – specifically Perkins' defensive approach to value investing – consists of the hunt for this type of asymmetric payout structure: Relatively modest downside risk offset by much more significant upside potential. These are the "bargains" we seek as we scrutinize our investment universe for opportunities.

Of course, there are challenges involved in the pursuit of these stocks. Perhaps the most well-known is the "value trap," although the term is rarely well-defined. What is a value trap? It's not simply a low-priced stock that has underperformed. A value trap is a stock that has fallen out of favor and appears cheap, but will nonetheless continue to underperform the market over time. The teaser is the low valuation and negative sentiment surrounding the stock, but the punch line is an adverse outcome. Value traps can take the form of a "landmine" and see a devastating decline; the stock may simply go nowhere while the aggregate market moves much higher, leaving the owner far behind in relative terms; or, it may fall into the range of possibilities for the magnitude and velocity of decline in between these extremes.

In our view, many of the industries and stocks which have declined the most in recent years are more likely to prove value trap than bargain. Natural resource companies with little control over critically-important commodity prices and burdened with overleveraged balance sheets serve as an example of the type of value trap we see among the stocks that underperformed most dramatically. Banks that aggressively expanded their loan books, have inadequate loan loss reserves, and have too little capital are another example of potential traps in today's market. There are many others as well. While it is good news that certain stocks are falling out of favor, affording the bargain investor the opportunity to be contrarian, care is required. This is especially so after such a long and enduring bull market, which may leave many value investors quite "hungry" for opportunity (as has been pointed out in the past by noted value investor Seth Klarman). Drawing this distinction – bargain from trap like wheat from chaff – is a central challenge in today's markets.

IDENTIFYING THE CLASSICS

Value-oriented investors are presented with potential value traps on a daily basis. Over many years of experience and reflection, our team has come to know a variety of value trap "types" – what we have come to think of as "the classics." Perhaps similar to the art collector wanting to avoid a fake, the value investor is well advised to keep a few typical characteristic profiles in mind. While neither the only possibilities nor mutually exclusive, we consider the following five value trap types essential knowledge for the informed buyer.

THE CIGAR BUTT

Synonymous with Benjamin Graham and his original formulation of value investing, the "Cigar Butt" trap comprises generally low quality companies which do not compound value over time. Such stocks, however, may trade cheaply. Ultra-competitive industries with low returns on capital and questionable industry discipline are often home to this type of stock. Overly indebted balance sheets and poor cash flow dynamics tend to exacerbate the situation. While a profitable trade is possible – the last "puff" of the cigar, so to speak – compounding significant value over the long-term is very unlikely. Should business value in fact erode over time, an investor may be left holding a stock with mostly downside risk.

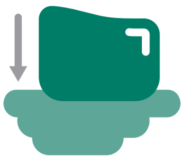
CHEAP ON PEAK

Commonly having economically sensitive or product cycle driven businesses, these potentially high quality companies see wide variance in their earnings streams. When they trade cheaply on unsustainably high sales and margins – watch out! Recognizing this value trap is particularly important in today's market environment. Autos, mining and construction equipment, temporary staffing, and consumer electronics are all examples of industries with earnings streams that may look very strong at the high point of the cycle, but can decline precipitously in an economic or product cycle downturn. While these companies may be market leaders, when the cycle turns lower estimates of business value also come under great pressure and scrutiny, often leaving the "value" buyer wondering what happened.

COMPETITION CATCHES UP

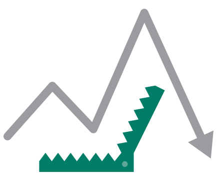
A once high quality company watches other industry players improve their operating capabilities, leaving the former star player with much lower profitability, and perhaps sales, than were achieved historically. Competition is the rule, not the exception, across sectors and geographies. Whether in product innovation, low-cost operations, the acceptance of narrower margins/returns, or some other aspect of the business, nearly all companies will face competitive pressures over time. If the star player doesn't maintain its competitive advantage, then both profits and valuation multiples may permanently decline. The transition of a stock from "market leader" to merely ordinary can be a painful one for investors.

THE MELTING ICE CUBE



This type of trap may appear to simply be a hybrid of "Competition Catches Up" and "Cigar Butt," but is worth noting in its own right. The hallmark of a melting ice cube is a structural flaw of some kind relentlessly eroding business value, often taking many years to play out. In the meantime, a cheap valuation entices the value-minded investor. The weakness may be at the industry level, for instance, as seen in the newspaper and telephone directory/yellow page industries over the past decade, both of which have struggled with disintermediation by the Internet. While the business generates free cash flow and thus has some value, that value is in decline. Thus, the market is not incorrect in assigning a low multiple, and a re-rating upwards is unlikely. Buying a stock when time is the enemy is a very difficult way to make money, regardless of price.

VOLATILITY TRAP



Also very timely given recent market wobbles, this variant of value trap is characterized by a sudden and significant drop in a stock's price, typically due to some news event. In the heat of the moment, the value buyer may conclude the stock is therefore out of favor and cheap. However, fundamentals can change and perspective is warranted. For example, OPEC's changing intentions in late 2014 sent oil and gas stocks sharply lower. Yet even after that slide, the market hadn't adjusted nearly enough to the new, grimmer realities facing these companies. That a stock is down meaningfully over a short period of time does not necessarily equate to an attractive investment opportunity. Maybe it was too expensive to begin with, or maybe the new facts are truly troubling. As for "buying the dips," we'd offer a slightly modified mantra: *Examine the dips, buy value.*

METHODS OF AVOIDANCE

A familiarity with the common “types” of traps can help to avoid them. However, deeper analysis of fundamental and valuation characteristics informs the type of trap, and ultimately is required to gain a clear understanding of a stock’s risk/reward profile. One over-arching principle is to ask a lot of questions. Perhaps no single question is more important in the effort of value-trap avoidance than: How (and how much) could this investment lose? Midway through 2016, many cyclical stocks have been under pressure, populating the radar of value investors. Earning power under various economic scenarios is therefore a key consideration. What if that key commodity price stays down for years, what will earnings be? Balance sheet strength – specifically the ability to endure a severe downturn – is another central question to analyze. Is the debt burden manageable with a much weaker end market and resulting lower revenues and profits? There is a lot to consider. We organize our “methods of avoidance” along the following four lines of thought:

COMPETITION

The analytical framework of “Porter’s Five Forces” is a crucial tool for identifying risk. Does the company have a competitive advantage? Will the advantage endure? Has something about the company’s competitive position changed? Could you “set it and forget it”? A methodical examination of each force – existing rivals, customers, suppliers, new entrants and substitute products – can lead to a reasonable understanding of industry dynamics and help inform an assessment of a particular company within those dynamics. Return on invested capital, and its profit margin and asset turnover components, is a key metric to understand when evaluating a company’s competitive position. Are returns declining over time, and if so, why? End market considerations (growth potential, pricing power, etc.) are embedded in this analysis. All companies face competition in one form or another, and an understanding of those dynamics – looking forward not backward – can help identify potentially negative outcomes.

BALANCE SHEET

A company’s financial position – particularly if it is weak – can loom large in the outcome of an investment. Can the balance sheet endure a period of weak earnings? Are the assets as valuable as Generally Accepted Accounting Principles (GAAP) figures suggest? Is the maturity profile of debt matched with likely cash flows? Does the balance sheet have the capacity required for additional investment in the business? Strong balance sheets – characterized by plenty of liquid assets and modest debt burdens – afford companies flexibility when facing challenges. This is true for both macroeconomic and company-specific challenges, whether anticipated or exogenous shocks. Both sides of the balance sheet matter in this analysis, and the questions asked should be forward-looking in perspective. Is the bank’s loan portfolio adequately reserved given developments in the oil patch? Are the industrial company’s fixed assets correctly valued, given persistently low returns on equity? Is the debt burden manageable with a reduced earnings outlook? Debt-financed acquisitions and stock buybacks deserve special attention, as reduced financial strength can heighten risk profiles relative to the past. Equity recapitalizations and other forms of balance sheet repair can destroy per share value, and thus are best identified in advance.

VALUATION

Of course valuation matters to value investors. How could it not? But it’s not that simple; there is nuance to consider as well. How (and how much) could this investment lose? Developing a downside price scenario at the outset allows investors to explicitly consider the negative possibilities. Stocks can be cheap for a reason, and it’s important to be creative and thoughtful about what might go wrong.

A related question which can help clarify thoughts on valuation: If the stock falls 10% after purchase, is it then even cheaper? Or is it a mistake?

Equally important is the upside potential. What is the business worth in a strong operating and stock market scenario? Identifying stocks which have asymmetric payouts – not too much downside risk, and significantly more upside potential – should be the central focus of stock selection work, in our view. Is the stock cheap relative to its history, but not versus peers? Perhaps the company has changed for the worse, now more closely resembles peers and, therefore, should trade like peers. Is the stock cheap relative to an expensive market and peer group? It can be worth remembering that relatively inexpensive stocks can and often do re-rate lower, as operating results disappoint. In the context of a discounted cash flow analysis, remember the typically outsized impact of the early years and the terminal value, especially in relation to changing growth expectations. Valuation analysis should also take an enterprise value perspective to capture both equity and debt claims on the company's cash flows.

MANAGEMENT

Strategic, operational, and capital allocation decisions are key drivers of business value over time, thus assessing management is critical in avoiding value traps. What is the CEO's track record of strategic choices? Have the CEO and CFO run a tight ship from a cost perspective? Have they converted accounting profits into free cash flow? Consideration of management tenure, insider ownership and incentive-based compensation structures can help further inform a thoughtful opinion of corporate leaders. Ultimately, the question becomes: Will management steer the company in a reasonable manner over time, or not, and why? More broadly, does management control the company's destiny, or do external forces (e.g., commodity prices, irrational competition, etc.) dominate? Warren Buffett has famously noted that when good management meets a bad business, it is most often the business's reputation which emerges intact. An additional word of caution when assessing management: They are selling their side of the story. It is the investor who needs to consider the fuller picture, negatives included.

CONCLUSION

Despite our understanding of the pitfalls of value traps, we recognize that there are no perfect stocks. Tradeoffs are inevitable when deciding whether and when to invest, and we understand that value stocks are often discounted for a reason. However, we believe that our investment philosophy, which focuses on companies with healthy balance sheets, strong and consistent free-cash-flow generation, earnings stability and attractive competitive positions, helps us to identify higher-quality companies that are unlikely to fall into the classic value trap categories. We actively employ the methods of avoidance outlined in this paper while managing our portfolios. Additionally, we continue to research and analyze the stocks we include in our portfolios in an effort to ensure that we haven't inadvertently ended up in a situation that could become a value trap. This also gives us the opportunity to exit a potential trap as soon as possible once it's been identified. Our primary focus continues to be fulfilling our client commitment by striving to minimize downside losses while participating in the upside market gains in order to compound returns at a higher rate over a complete market cycle.

MINIMIZING THE IMPACT OF A VALUE TRAP

Building a strong portfolio involves more than the process used for selecting individual stock components. While avoiding value traps is the ultimate goal, the investor's approach to portfolio construction can help limit the damage when an investment fails to work out as expected. Stocks, almost by definition, involve risk. Even when a stock is thoughtfully vetted and potential outcomes are asymmetric in the buyer's favor, a negative outcome is possible. How exposed is the portfolio to any one risk? Investors can aim to limit the damage any one particular source of risk can have on the aggregate portfolio by diversifying across risk exposures – beyond sectors and countries, really down to fundamental and valuation drivers. Excessive or thoughtless concentration can be dangerous. How will the portfolio react to a significant change in the investment environment? It's also crucial to pay attention to correlations across the portfolio, and recognize that relationships between positions can change over time. While no one can know exactly what the future holds, we believe investors can aim to have at least a part of their portfolios doing relatively well regardless of the environment. Conversely, it can be a trap of sorts to have a portfolio which is "over-fitted" to a particular environment, only to have the overall market trend change to something different and unanticipated. In our view, holding a well balanced portfolio is an essential method for minimizing the damage caused by value traps, both the "classics" previously identified and the potential trap of a changed market environment.

CASE STUDY: STANDARD CHARTERED PLC

Standard Chartered is a UK-based, internationally-focused bank with key footprints in Asia, the Middle East and Africa. It could be considered a "**Cheap on Peak**" type of value trap, as the Asian and commodity credit cycle drove earnings, profitability, and the balance sheet to unsustainable levels.

STANDARD CHARTERED PLC STOCK PERFORMANCE
(8/31/96 – 8/31/16)

Source: Bloomberg.

VALUE INDICATORS

- Standard Chartered enjoyed a fairly "good" global financial crisis as most of its markets embarked on expansionary fiscal policies in 2009-2011, fueling dramatic asset growth and propelling the stock to an all-time high.
- By early 2015, however, profits were under pressure due to weaker loan demand, higher credit provisions, increased competition and lower interest rates. The stock fell nearly 50% (in U.S. dollars) from its 2013 high, and valuation compressed to 8x forward price-to-earnings ratio (P/E) and 90% of tangible book value.
- Standard Chartered hired a new CEO in mid-2015, who was very well regarded at JPMorgan Chase. This added to the allure for many value investors.

RED FLAGS

- The company had balance sheet weakness, specifically underappreciated credit risk in the bank's Asian and commodity loan books. Moreover, the bank had too little capital to absorb likely losses, especially when measured against its peers. The company would likely need additional equity capital, thereby diluting existing owners.
- In addition, increased competition in Standard Chartered's key transaction-finance business was unlikely to relent. The new CEO seemed likely to be a case of a good manager meeting a bad business, with the business's reputation likely to remain intact.

OUTCOME AS OF AUGUST 31, 2016

Since June 30, 2015, the stock is down approximately an additional 45% (in U.S. dollars).

CASE STUDY: POWELL INDUSTRIES INC

Powell Industries is a U.S.-based manufacturer and assembler of electrical power products. Powell provides equipment and systems for the distribution, control and management of electrical energy and process control systems. It could be considered a "**Volatility Trap**" type of value trap as the company's fortunes are tied in large part to the ebbs and flows of the energy cycle.

POWELL INDUSTRIES INC STOCK PERFORMANCE
(8/31/96 – 8/31/16)

Source: Bloomberg.

VALUE INDICATORS

- Since the financial crisis, the company has maintained a balance sheet with net cash.
- Historically speaking, valuation bottomed at 1.0x book value in recessionary environments (2003) and during the financial crisis (2008). In late 2014, the stock was trading at a 30% premium to book value which may have appeared attractive relative to other industrial companies, especially given the company's strong balance sheet.

RED FLAGS

- The company's fortunes are tied in large part to the ebbs and flows of the energy cycle. The peak in free cash flow generation occurred in 2009 and 2010, driven in large part by declines in working capital. Subsequently, the company generated cumulative negative free cash flow since the peak, with erosion of return on invested capital (ROIC) during this time as well.
- The capital intensity of the business was also concerning: during the past four years, capital expenditures increased far faster than depreciation, depletion and amortization while earnings per share declined.
- There does not appear to be much of a moat for the company. Powell buys most of their parts from other companies which can result in limited intellectual property. Their business model largely focuses on assembling these parts into a final product. This often results in a low margin, low returns business.

OUTCOME AS OF AUGUST 31, 2016

Since December 31, 2014, the stock is down 19%, while the Industrial Select Sector Index is up 3%.

Investing involves risk, including the possible loss of principal and fluctuation of value.

The views presented are as of 08/31/16. They are for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation for any security or market sector. No forecasts can be guaranteed. The opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent, and are subject to change at any time due to changes in market or economic conditions. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties with regards to the results obtained from its use. It is not intended to indicate or imply in any manner that any illustration/example mentioned is now or was ever held in any Janus portfolio, or that current or past results are indicative of future profitability or expectations. As with all investments, there are inherent risks to be considered.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Any portfolio risk management process discussed includes an effort to monitor and manage risk which should not be confused with and does not imply low risk or the ability to control certain risk factors.

There is no assurance that the investment process will consistently lead to successful investing. There is no assurance the stated objective(s) will be met.

A client commitment is not a guarantee that a stated objective will be met.

Discounted Cash Flow (DCF) Analysis is a valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis uses future free cash flow projections and discounts them (most often using the weighted average cost of capital) to arrive at a present value. This is used to evaluate the potential for investment. If the value arrived at through DCF analysis is higher than the current cost of the investment, the opportunity may be a good one. As precise cash flow projections can only be made into the near future, the **Terminal Value** component of a DCF model represents the discounted cash that can be taken from a business during its remaining life; the firm's value for the time beyond the explicit forecast period during which more precise cash flow projections can be made.

Price/Earnings Ratio is a valuation ratio of a company's current share price compared to its per-share earnings. This ratio represents equity securities within the portfolio, and is not intended to demonstrate the growth of the portfolio, income earned by the portfolio, or distributions made by the portfolio.

The **Industrial Select Sector Index** measures the performance of those industrial companies within the S&P 500® Index.

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