



Searching for Value in a Down Market

Buying on the dips is a favorite strategy of committed stock investors. But when looking for investment bargains, it's important to avoid a value trap.

Callout:

Value stocks are those that have fallen out of favor in the marketplace and are considered bargain-priced compared with book value, replacement value, or liquidation value.

Social Media Message:

Seeking value in this volatile market? Learn tips on when to buy and when to stay away.

As volatility in the stock market continues, some investors may be tempted to buy on the dips. But this desire raises an important question: Is a low price by itself a true measure of a value stock? If an investor plans to hold a stock for the long term, how can an investor gauge its future potential compared with the broader market?

Value Investing Defined

Value stocks are those that have fallen out of favor in the marketplace and are considered bargain-priced compared with book value, replacement value, or liquidation value. Value fund managers typically invest only when they believe the underlying company has good fundamentals. Many value investors think that a majority of value stocks are created because investors overreact to negative events, which can include:

- Disappointing earnings.
- A negative outlook for the industry.
- A regulatory setback.
- Substantive litigation.

The idea behind value investing is that stocks of good companies will bounce back in time when a company overcomes a short-term obstacle and investors ultimately recognize fair value. But this recognition may take time or, in some instances, may never materialize.

Comparative Analysis

Investors looking to avoid a value mistake may want to compare a stock's recent trend with a peer group or with a broad market index. Here are some other suggestions:

- Consider whether a stock has dropped more than the average stock in the S&P 500 during the past three months.
- Examine whether earnings estimates are being revised downward faster when compared with a peer group.
- Compare analyst estimates of future profit margins to historical margins. If expectations for future profits exceed past earnings, the company could end up disappointing investors.

Another technique for potentially avoiding a value mistake is to look for stocks paying dividends. Dividends historically have been seen as a sign of management's confidence in healthy cash flow over the long term, as well as an indicator that management's interests align with shareholders. Even if a stock price languishes for a period of time, a dividend provides an investor with something in the way of a return. Note that dividends are not guaranteed, and a company can reduce or eliminate a dividend at any time.

Perhaps the best strategy for avoiding a value mistake is to combine value stocks with growth stocks, international stocks, and other types of equities to pursue diversification. Although there are no guarantees, owning some of each could help to balance an equity portfolio over the long term.¹

Source/Disclaimer:

¹ *Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors. Investing in stocks involves risks, including loss of principal.*

###

December 2011 — This column is provided through the Financial Planning Association, the membership organization for the financial planning community, and is brought to you by Paul Lemon, CPA/PFS, CFP®, a local member of FPA.

Required Attribution

Because of the possibility of human or mechanical error by McGraw-Hill Financial Communications or its sources, neither McGraw-Hill Financial Communications nor its sources guarantees the accuracy, adequacy, completeness or availability of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. In no event shall McGraw-Hill Financial Communications be liable for any indirect, special or consequential damages in connection with subscriber's or others' use of the content.