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5 Sinking Stocks To Avoid In The Market Storm

Markets are getting restless. Valuations are stretched, the global economy is shaky, and after six years of a bull market investors are taking every excuse to sell. Now, more than ever, it's important to own quality businesses at fair valuations.

Want proof? Look at what's happened recently to some of the companies we've put in the Danger Zone. These are all companies with low or negative profitability and massive growth expectations embedded in their market valuations. Our past 26 Danger Zone calls are on average underperforming the market by 55%.

Five of these stocks have dropped by over 25% and still earn our Dangerous-or-Worse rating. Investors should avoid these sinking stocks that still have further to fall.

Demandware (DWRE)

Demandware landed in the Danger Zone in June, and Barron's highlighted that call again on September 26. For a long time, investors kept rewarding the company for its high revenue growth and ignoring the fact that in over a decade of operations it's yet to turn a profit. Moreover, with increasing competition from other young cloud companies as well as giants like Oracle, IBM, and HP means DWRE has little room to raise prices or cut back on its marketing efforts if it wants to retain market share.

DWRE's lack of profits finally caught up to it when the company reported wider than expected losses on August 4. Combined with disappointing guidance, the news helped send shares down nearly 10%, and they've been in free fall ever since, now down 28%

Even with the drop, shares remain expensive. When we first made our call, the market valuation of $72/share implied that the company would achieve pretax margins of 5% and grow revenue by 31% compounded annually for 18 years. Now, with the price down at $52/share, the market implied growth appreciation period (GAP) is still 16 years. That's a long horizon for profit growth in a rapidly changing industry.

Twitter (TWTR)

We warned investors to stay away from Twitter in June. High revenue growth wasn't leading to any profits, our adjustments showed that the company's losses were widening rather than narrowing, and the valuation implied massive revenue growth and margin improvement for the next 17 years.

In the past 3+ months, TWTR is down 30%. The most recent quarter showed a significant slowdown in user acquisition, as monthly average users (MAUs) only grew by 15% from the year before. The company has warned that growth could be even slower in the future as it struggles to win over the "mass market".

Without exciting user growth numbers, investors were left with the company's losses and high valuation, and they punished the stock accordingly. Still, the valuation implies that TWTR can reach a 5% pre-tax margin and grow revenue by 32% for the next 13 years. Those are optimistic forecasts for a company experiencing a significant slowdown in user growth.

El Pollo Loco (LOCO)

Remember when people were calling this "the next Chipotle?" Even back in March, when shares had already fallen 35% from their peak, there were bulls touting a comeback story and arguing that LOCO had the potential for massive growth. We showed that while LOCO may be priced like Chipotle, it doesn't come close in terms of growth or return on invested capital (ROIC).

With thin margins and business heavily concentrated in the Los Angeles area, we expressed doubt that LOCO could successfully expand eastward, and we pointed out the impact California's rising minimum wage would have on margins. So far in 2015, slowing growth, weak traffic, and slimming margins have all contributed to a 60% drop in LOCO's stock price.

Now trading at around $11/share, LOCO is no longer priced like Chipotle. In fact, its price to economic book value of 1.6 is now comparatively cheaper than the market. Still, LOCO's poor ROIC, misleading economic earnings, and negative free cash flow continue to earn it our Dangerous rating.

CenturyLink (CTL)

Don't think all our ire is reserved for young, high-growth tech stocks. That happens to be a particularly overvalued segment of the market right now, but there are plenty of other companies with poor operating metrics and expensive valuations, such as telecom giant CenturyLink.

CTL has not earned an economic profit in any year in our model dating back to 1998. The situation only got worse with its acquisition of Quest in 2011, a deal that cut its already low ROIC in half and burdened it with an extra $16 billion in debt. This heavy debt makes it tough for the company to invest in new strategic initiatives to offset the declines in its legacy businesses.

Since our call in early February, CTL shares are down 38%. Even still, the valuation still implies that the company can stabilize its margins and return to growth in the next couple of years, something it's shown no sign of doing so far.

Box (BOX)

We put BOX in the Danger Zone shortly after its IPO in January. The company's highflying IPO price ignored its significant competitive pressures and its hidden liabilities from off-balance sheet debt and outstanding employee stock options.

BOX has attempted to carve out a niche in cloud storage for enterprise customers, but with competitor Dropbox now making a push to convert many of its 400 million users (more than 10 times what BOX has) to paid business accounts, it might face more pressure on that front. The most recent quarter saw continued evidence that BOX is struggling to turn revenue growth into profits, as gross margin fell to 72% from 79% the year before.

Even after a 42% drop in its stock price, BOX still has significant growth expectations embedded in its valuation. In order to justify a price of ~$12/share, it would need to achieve 5% pre-tax margins while growing revenue by 22% compounded annually for 17 years.

Stay Off The Sinking Ships

These stocks are going down, and the numbers tell us they have farther to fall. If you own one of these stocks, it's time to cut your losses and move on. Everyone else should stay far away and look for more profitable companies with cheaper valuations.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?
ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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