8 red flags to watch out for when investing

South Africa has been rocked by a series of corporate scandals in recent years that have sent the share prices of former blue-chip companies like Steinhoff and EOH plummeting from their previous stratospheric highs. Investors who bought shares in both since January 2017 would have lost roughly 98% and 80% of their money respectively. One of the biggest questions on the minds of the public is: How on earth did this happen?

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"When scrutinising these former market darlings, a similar picture appears. Of course it isn't a save-all and it is impossible to always get things right, but knowing how to spot the red flags can help investors stay clear of high-risk companies," says Duncan Artus, portfolio manager at Allan Gray.

Artus discusses some of the top investment red flags that may together paint a picture of a high risk investment.

- ## Redflag #1: The cult of the celebrity CEO

  There's nothing more appealing than the rags-to-riches story of someone who has come from nothing and risen to the top of the corporate hierarchy. Unfortunately, the hype created around a CEO's public persona isn't always matched by reality. A company built around the profile of its leader should be scrutinised.

- ## Redflag #2: Aggressive expansion (often internationally)

  Companies that suddenly go on aggressive offshore expansion drives tend to use a lot of capital to make forays into markets they are often unfamiliar with.
  Many South African companies that have recently expanded into unfamiliar territories ranging from the US (Discovery, Old Mutual) to Australia (Woolworths) and Nigeria (Tiger Brands), had to return home with a "bloody nose", or report struggling numbers following their acquisitions.

- ## Redflag #3: An absence of cash flow

  Poor cash flow is one of the biggest signs that all is not well with a company and the way it manages its finances. This is like someone who has a good job, drives a nice car, lives in a great house or apartment but is always broke. Companies that are perpetually short of cash and fund their day-to-day operations with credit, are often poorly managed. We think of cash flow as the cash from operations less the capital expenditure required to maintain their assets. The inability to actually produce any cash is a red flag.

- ## Redflag #4: Significant share issuance/growth in absolute levels of net debt

  Equity capital is valuable because it is scarce. If a business is undervalued, issuing shares is a very expensive way of raising capital. Any share issuance dilutes existing investors into perpetuity.
  Rising debt levels are a concern: you are taking from the future and spending today. Not only does that leave a hole that one day needs to be filled, but servicing that debt can quickly overwhelm a business. It is important to determine whether the borrowing is warranted. Very often it is not.

- ## Redflag #5: Overly complex corporate structure

  The more convoluted a company's corporate structure the easier it is to hide financial malfeasance.
  Often companies will deliberately make use of complicated cross holdings, shell companies and an array of subsidiaries – frequently in different jurisdictions – to make it difficult to track precisely what they are doing. This is often reflected in overly complex financial reporting, which can also conceal debt levels or artificially inflate earnings.

- ## Redflag #6: Related-party transactions

  Cross shareholdings and active trading in shares between subsidiary companies can result in inflated asset values across related companies. The share prices go up because of the increased buying without any fundamental changes to the underlying businesses. This is something investors need to look out for.

- ## Redflag #7: Everyone is doing it (don't follow the herd)

  Avoid falling into the dreaded FOMO trap, or fear of missing out. Just because everyone else is investing in something, it doesn't mean you should be doing so as well. We've seen the cryptocurrency craze that pushed up the price of Bitcoin to almost $20,000 only to see it crash to under $6,000, all in the space of half a year.
  This is precisely how bubbles, such as the tech bubble of the late nineties develop.

- ## Redflag #8: Be wary of noise created by fear and speculation

  Activist short sellers have been a prominent feature in stock markets for many years. It's easy to get caught up in the hype when their ideas hit the news. But a disciplined investment process, applied consistently over time, helps to overcome the temptation to pile in (or out) based on the headlines.

"Assessing the risk/reward trade-offs and margin of safety is a key consideration of a robust investment process, and even more crucial amid uncertainty and activist short-seller rumours. Make sure you choose a long-term manager whose investment process takes this into account," concludes Artus.