Exit Signals and Red Flag Classification

1. Signals

The following are exit signals that are **investigation triggers, not automatic liquidation rules**. They are designed to flag potential overvaluation, quality deterioration, or structural breakdowns that require deeper review.

Overvaluation Signals:
- $P/FCF > Industry\ average$
- $P/B > Industry\ average$
- $P/E > Industry\ average$

Quality Deterioration Signals:
- $ROE < 10\%$
- $ROA < 5\%$
- $ROE < Industry\ average$
- $ROA < Industry\ average$

  Signs deterioration may be temporary:
  - Revenue continues to grow
  - Free Cash Flow remains positive
  - Industry peers are also declining
  - ROE/ROA remain above cost of capital

  Severe deterioration:
  - $P/FCF \leq 0$
  - $P/E \leq 0$
  - $ROE < 0$
  - $ROA < 0$

2. Red Flag Types

Severe red flag:

$$(P/FCF \leq 0\ OR\ P/E \leq 0)\ AND\ (ROE < 0\ OR\ ROA < 0)$$

- The company is both unprofitable and failing valuation screens.
- Possible structural impairment.
- Requires urgent reassessment.

Value trap (cheap & deteriorating):

$$\begin{gathered} No\ overvaluation\ signal \\ AND \\ \big((ROE < 10\ \&\ ROE < Industry\ average)\ OR\ (ROA < 5\ \&\ ROA < Industry\ average)\big) \end{gathered}$$

- A deteriorating business with no catalyst.
- Market may re-rate the stock downward
- Quality may dip temporarily

Expensive deterioration (overvalued & deteriorating):

$$(At\ least\ 2\ overvaluation\ signals\ AND\ at\ least\ 2\ quality\ signals)$$
$$OR$$
$$(1\ overvaluation\ signal\ AND\ any\ severe\ signal)$$

- Market is pricing in growth that is failing. The market hasn't realized deterioration yet.
- Sometimes stocks peak when fundamentals have already started rolling over
- Sometimes deterioration is temporary (one bad quarter, cyclical downturn, investment phase).

Quality compounder (overvalued & performance isn't too bad):

$$3\ overvaluation\ signals\ AND\ (ROE\ <\ Industry\ average\ OR\ ROA\ <\ Industry\ average)$$

- The market is pricing in strong expectations
- Fundamentals are strong but valuation is stretched
- High-quality companies often trade above industry averages for long periods.

Watchlist zone:

$$1\ overvaluation\ signal\ OR\ 1\ quality\ signal$$

- Early signs of change but insufficient evidence for reclassification.

Additional Considerations

Before executing an exit, we should check for other information to prevent:

- Selling into temporary noise
- Exiting during reinvestment phases
- Misreading accounting distortions
- Getting shaken out of compounders

1. Check Whether Deterioration Is Structural or Cyclical

If peers are also declining, the issue may be cyclical. Deterioration may be temporary if:

- Revenue decline is industry-wide
- Margins compressed across peers
- Commodity/input prices moved

2. Checking Quality Metrics Across Multiple Periods

Checking quality deterioration over time is an important guard against false exits. Single-period signals can be noise, especially in undervalued stocks or cyclical businesses.

Look at YoY and QoQ comparisons simultaneously:

- QoQ shows short-term fluctuations
- YoY smooths seasonality and one-off events

3. Examine Capital Allocation Changes

A drop in ROE may not be bad if:

- Company is deleveraging
- Investing in high-return projects
- Making acquisitions

4. Check Macro Sensitivity and Market Behavior Context

Before exiting, consider:

- Interest rate changes
- Commodity prices
- FX shifts
- Regulatory changes
- Market sentiment

5. Check Management Guidance & Tone, Insider & Buyback Signals

Before exiting, review:

- Earnings call transcripts
- Forward guidance changes
- Language shift (confidence → caution)
- Insider buying during weakness is often powerful confirmation.