What Should You Do if You Caught a Falling Knife?

Description

Investors don’t want to catch a falling knife, because doing so will hurt their portfolios — at least in the short term. What should you do if you happen to catch one?

Let’s use **Cineplex Inc.** (TSX:CGX) as an example. Take a look at Cineplex’s long-term chart. From the seemingly stable high $50 to low $40-per-share level that the stock had traded for about two years, it has quickly turned and fallen +40% to the $30-per-share level.

What should an investor do if they’d bought the stock at, say, the $36 level, thinking that it was all right to start buying at that point? That’s the danger of buying a falling knife. It can fall further — much

The dividend doesn’t stop the bleeding

When a stock falls as Cineplex has, the dividend doesn’t save shareholders from the price drop. The stock offered a yield of ~4.7% when the stock was trading at the $36-per-share level.

The stock has fallen nearly 15% since then. So, even after investors receive the dividend payouts for the whole year, their position would still be underwater by ~10%.

However, the dividend is a helpful psychological factor for the shareholder to hold on. And if the stock recovers to higher levels, the ~10% drop will be a temporary drawdown — unless the shareholder sells at a loss.

Revisit the reasons why you bought the stock

Investors should not panic when they buy a falling knife that keeps on falling. They might have originally bought the stock for a number of reasons. In the case of Cineplex, it could be that investors found Cineplex to be a well-run company and perceived its monthly dividend to be safe.

Moreover, the company has a leading position in the box office market with ~78% of the market share. Of course, that is now a negative for the stock, as it has recently reported declining attendance at its theatres.

Whatever the reasons you bought the stock, determine if they still hold true. Then re-evaluate the company to determine what has changed.

What has changed about Cineplex?

Cineplex is transforming. The company is diversifying into other areas of entertainment and food, including investing in The Rec Room and Playdium. It plans to build 10-15 of each in strategic locations in Canada. As well, Cineplex has partnered with Topgolf to open multiple Topgolf venues in the country.

These investments will occur throughout the next few years, and they could take some time before they start contributing meaningfully to the company's earnings and cash flow.

Investor takeaway

Cineplex stock has fallen a whole lot in the last six months or so. It was overvalued before the drop and is now better valued. If the company manages to spur growth with its investments, the stock can make a strong recovery in the next few years. If you believe the stock will turn around, Cineplex becomes a stronger buy the lower it falls.

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