Beginners: If You Chase a Falling Knife Like This Stock, You'll Get Hurt

Description

When it comes to spotting value, you really need to do your homework, because there are many toxic stocks that could blow up as soon as you pick up shares. Remember: just because a stock is cheap doesn't mean it's undervalued. There are many stocks that are "cheap" based on traditional valuation metrics, but there's a reason for the cheapness, and many new investors are forgetting that a cheap stock can and likely will get even cheaper.

One does not simply uncover the best of bargains by running a screener on stocks with low price-to-earnings (P/E) multiples, or any other valuation metric, for that matter. You need to determine the reason why a stock's as cheap as it is and whether or not it will drastically affect the company's long-term growth thesis. I believe chasing low P/E stocks blindly is just as bad, if not worse, than chasing momentum stocks without doing your homework.

Just because a stock has plummeted by X% does not mean it can't plunge by another X%. Depending on the situation, catching a falling knife could hurt those who attempt to catch it. Many new investors learn this the hard way.

They purchase shares of a single-digit P/E stock, thinking it's overly beaten up and can't possibly continue to fall. What they may not know is that P/Es can correct themselves and go up without experiencing a meaningful increase to a company's earnings. You get an increased P/E multiple in one of two ways: either the stock price appreciates (what we're used to) or the earnings fall off a cliff.

If earnings fall off a cliff, then the stock will need to correct itself, and next thing you know, you'll be left with a stock of the same P/E multiple and major capital losses, or a smaller magnitude of capital losses and a P/E that implies the stock in question is ridiculously expensive. Either way, an investor caught holding such a value trap is left between a rock and a hard place and is forced to throw in the towel on a stock that they thought was dirt cheap and would appreciate to a P/E that's more in line with industry averages.

Corus Entertainment Inc. (TSX:CJR.B) is just one example of a value trap that's hurt a lot of investors who have tried to catch it on its violent multi-year crash. The stock trades at a mere 7.47 P/E with a gigantic dividend, which yields just south of 16%, attracting aggressive income investors looking to give themselves a raise.

Unfortunately, the stock has really been absurdly cheap in the years following the beginning of its 2014 decline. At first, the stock plunged 50%, which is normally what many investors deem as the maximum that a quality stock can fall for some reason. Maybe it’s because market crashes in the past have typically fallen by ~50% before rebounds. This is a common fallacy, and new investors should rid themselves of thinking this way immediately.

After Corus fell 50-60%, guess what happened next?

It bounced back and appeared to have formed a bottom, only to fall another ~50% from peak to trough, devastating rebound hunters who thought Corus would be a rewarding rebound play.

The stock is now down ~72% from all-time highs, and I’d encourage investors to stop chasing falling stocks blindly. It’s really just as bad as chasing a speculative bubble like Bitcoin or other cryptocurrencies. Buying something that you don’t fully understand is a sure-fire way to go broke in a hurry.

Bottom line

Catching a falling knife is dangerous, and if you’re going to attempt it, ensure you’ve done your due diligence and have a plan if it doesn’t end up working as expected by either averaging down or throwing in the towel. If a stock blows up in your face, you’ll need to know how to react accordingly in compliance with your investment thesis.

Remember, just because a stock is cheap doesn’t mean it can’t get cheaper.

Stay hungry. Stay Foolish.

CATEGORY

1. Dividend Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. TSX:CJR.B (Corus Entertainment Inc.)

PARTNER-FEEDS

1. Msn
2. Newscred
3. Sharewise
4. Yahoo CA

Category

1. Dividend Stocks
2. Investing

Tags

1. Editor's Choice

Date
2025/07/07
Date Created
2018/03/08
Author
joefrenette