Caution: 3 Ways to Spot Stock Price Fragility

Description

Over the past several years, there have been a number of stocks that have shot up significantly, only to fall to earth dramatically. Many investors were caught up in these stocks as they experienced dramatic increases in share prices. Unfortunately, these investors were also severely punished when the stocks came crashing down. If you're tempted to invest in these growth strategies, you need to be able to protect yourself from the possibility of an eventual downturn in prices.

This fall is extremely difficult to predict during the uptrend for a number of reasons. The financial news, for one thing, often makes it look as if these stocks can climb forever. There is always a narrative that pushes the belief in a never-ending rise in share prices. But there are usually warning signs that point to fragility. Remember: as investors, we do not know what *will* happen. *We only know what is more likely to happen.* Looking for instances of fragility can protect us from potential downside.

1. Look for excessive debt

Back in 2014, it seemed that Valeant Pharmaceuticals, now **Bausch Health Companies Inc.** (TSX:BHC)(NYSE:BHC) would never fall. Its roll-up strategy and cash flow growth seemed strong enough to support the share price. Unfortunately, the company had taken on excessive amounts of debt that made it susceptible to an external shock. When that shock occurred in the form of potential regulatory change towards drug prices, the stock came down fast and hard.

Growth by acquisition strategies often use debt to fuel growth. The shares then rise on the *belief* of future capital gains instead of fundamental value. When shares trade on hopes and dreams of debt-fueled growth, you can be reasonably sure that there is a high probability of downside built into the stock.

2. The charts don't lie

Another way to look for potential fragility and the potential for downside risk is to look at the shape of the stocks' chart. During the run-up in prices, the stock often begins to assume a parabolic shape, with the stock price heading straight up in a short amount of time. Once you see this shape, there is a good chance that there is a reckoning around the corner.

The problem is that of timing. While there is a high likelihood of downside, it's impossible to know when the stock will come back down. All you can be reasonably sure of is that there is more and more downside fragility with each passing day. A good rule of thumb is to assume that the stock will likely collapse within six months to 2 years. When that decent occurs, the stock can come down hard and fast.

AutoCanada Inc. (TSX:ACQ), another roll-up strategy, experienced rapid price acceleration very similar to that of Bausch. After approximately a year of rapid increases, AutoCanada's stock collapsed equally quickly. Valeant lasted longer than AutoCanada, with its price increase lasting from approximately mid-2013 to mid-2015. In the end, the results were the same.

3. Goodwill can be… anything

One balance sheet item to keep an eye on is goodwill. This can be a tricky item, and its meaning can be somewhat nebulous. Essentially, goodwill gives a value to a company's intangible assets. There is genuine use to the category. A brand like **Coca-Cola** has intrinsic value. You can't touch it, but it is worth more than other, lesser known, brands.

The problem is when goodwill becomes excessively large. Often when companies grow by acquisition, they assign values to the acquired assets that might be somewhat in excess of their actual value. If you want to see if a company is bolstering their assets, check the line on goodwill. A good rule of thumb is to check whether the company's assigned goodwill amount is larger than their hard assets such as property, plants, and equipment. If so, it's likely that the company has excessive goodwill and potential share price fragility.

Be aware

Keep in mind that even if these companies possess one or more of these issues, it does not mean you should not buy the stocks. It also does not make them bad companies. Just be aware that these factors make the stock prices fragile and more susceptible to downside risk.

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Date
2025/07/22
Date Created
2019/02/06
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