11 Things To Remember before Buying a Falling Stock

Often, we see prices of stocks collapse in a very short span of time. There could be many reasons. The most common ones are: discovery of a fraud or a dramatic change in regulations or a default or a rumour of default or promoter selling out. Satyam, Maytas, DLF, KS Oils, MCX, Infinite Computer Solutions, Indraprastha Gas, Educomp, SKS Micro, Gammon India, etc, are just a few that come to mind. There are many that have lost almost their entire valuation. A few have come back. Sometimes, it could be simple, plain rigging that collapsed or succeeded. I am sure that 90% of the 'tech' stocks of the 2000 tech boom era no longer exist or have just vanished. Remember Pentafour or DSQ?

Similarly, I fail to understand the price of a stock like Ricoh India, where there is an apparent fraud, but the market price still seems to imply that things will be well and the ridiculously high valuations can sustain. Looking at the rear-view mirror, we kick ourselves when stock prices crash and then, in less than a year, recover and become multi-baggers. Similarly, we also hold some stocks that have lost 90% or more of their value; but we do not like to sell below our 'cost'. That amounts to hoping that the stock will become a 10-bagger from here to enable us to just break even! In that case, why do we not put all our money into that? We humans are stupid when it comes to equities. We can rationalise anything.

I was wondering if it makes sense to just buy any stock should it fall, say, more than 20% in one trading session? I do not have any statistics to prove my assumption that it would be a losing strategy, if followed blindly. However, I must confess that I have, on more than one occasion 'punted' on such events. Given my innate pessimism, I have missed most opportunities (and disasters too) but made money on a few punts. Here, I go with the basic premise that I can lose everything I wager. What I am looking for is a 30%-50% return in less than six months. Absolute return, not annualised.

Here are some of my assumptions or conditions that need to exist, to make such punts. I will call them punts, because I am putting a wager on one or two major events that will happen and change the entire perspective. Or at least draw in enough crowd which will think that the stock has fallen too much and get in. Yes, it is often a dicey call and playing the 'greater fool' theory does not guarantee that you are not amongst one of those. An element of luck is also needed. Luck in terms of timing can make a big difference to the returns. I would look for some essential conditions to be fulfilled before I take a punt.

1. A business that exists and can be easily understood. For instance, Indraprastha Gas or MCX had businesses that were not too complex to understand.
2. A regulatory issue that can be politically resolved. For instance, Indraprastha Gas was robbed of its pricing power by a government fiat. It still kept the company profitable and there was a chance that the irrational fiat could be upturned by the legal process. Whilst all this goes on, the stock still has some value.
3. A company that is low on debt. Many frauds happen when companies keep throwing up profit numbers but the total debt keeps rising. I avoid such cases, since most of them would involve some jiggery-pokery in accounting and the reported profit numbers would be more fiction than fact. For instance, I look at companies like **Ricoh, Bartronics, Opto Circuits, KS Oils**, etc, and see debts going north each year. I would not invest in such stocks, at any price; so these are off my radar in any case.
4. A stock like **Satyam** was pure punt. There was an orchestrated bailout and the company had some good businesses MAYTAS was cleverly separated and the buyer got a lot of protection from the system.
5. **MCX** was a classic case where the problem is yet to be resolved but the stock has tripled or quadrupled ▸▸

from the lows it hit. Because it has some marquee names behind it, the company escaped a shutdown. I guess, this is one case where punters got lucky. Here, the issue was that there was a viable business and a lot of potential buyers. A business franchise existed (though I am not sure how much of the business was real and how much was not) and a yarn could be spun.

6. Cases like **KS Oils** were simply cases of fraud. Such businesses could never be so profitable. The stories were too good to be true. And what should have raised the alarm were the frequent visits to the capital market and the rising debt. This helped the frauds to survive. A good company should ultimately be lowering debt and not needing equity.
7. Infrastructure companies are a separate class. Here also, they all fail the cash-flow test and will not be seen in my shortlist. I know there are diehard fans of companies in this sector, but I do not understand this sector as well as they do. For me, if a company fails the cash-flow test, it is a business to avoid.
8. The best bets, often, turn out to be those companies that have good businesses, but miss one or two quarters of analysts' estimates. The business goes through a bad patch and then there is a recovery. Here, you may not make spectacular gains; but, often, are able to buy into a high-quality stock that is out of favour for the season. Remember the time when Suzuki and TVS Motors parted company? Yes, at that point in time, all seemed lost for the company. The only reason to place a bet at that time was the fact that the Indian partner was a TVS family member. Like when Cholamandalam Finance parted company with it Singapore partner. You bet on pedigree.
9. Commodity stocks are good bets when they trade at significant discounts to replacement costs. In general, commodity stocks are not worthy of investment; but they do provide trading opportunities when things look bleak for the sector. Yes, the wait could be uncertain, so the bets can be spaced out.
10. A stock named **Infinite Computers** cracked as some 'insiders' sold out before poor results. This kind of loss of faith can be very hard to be restored. Insider selling and buying is a very dicey area and we do not have a uniform way of interpreting the same. In some companies, insider action does not bother us and, in some, it does. So, a fall in price, based on such an action, need not guarantee that the stock will go up.
11. In the final analysis, these are high-risk/high-return trade opportunities. And very often, you do not have time to analyse, inquire and do work. You have to take a call on the spot. There are no friends, philosophers and guides on hand. And, remember, the basic action we are contemplating is one that is against the trend, that is, buying on a downtrend. Personally, I do not mind some punts in this category. One rule I follow is not to hang on to such investments for too long. A six-month time frame is what I keep in mind. Once I buy, I do keep track of the market actions, the trading volumes, etc, just to ensure that my selling is not delayed.

This also means that we need to have cash on our hands for such events. Alternatively, the conviction must be so strong that we are able to sell some of our holdings. I do not recommend this path for those who are on the SIP route. This is for those who are able to stomach losses and know what they are doing. ■

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