Headline: How to Catch A Falling Knife (Stock that is rapidly falling)	
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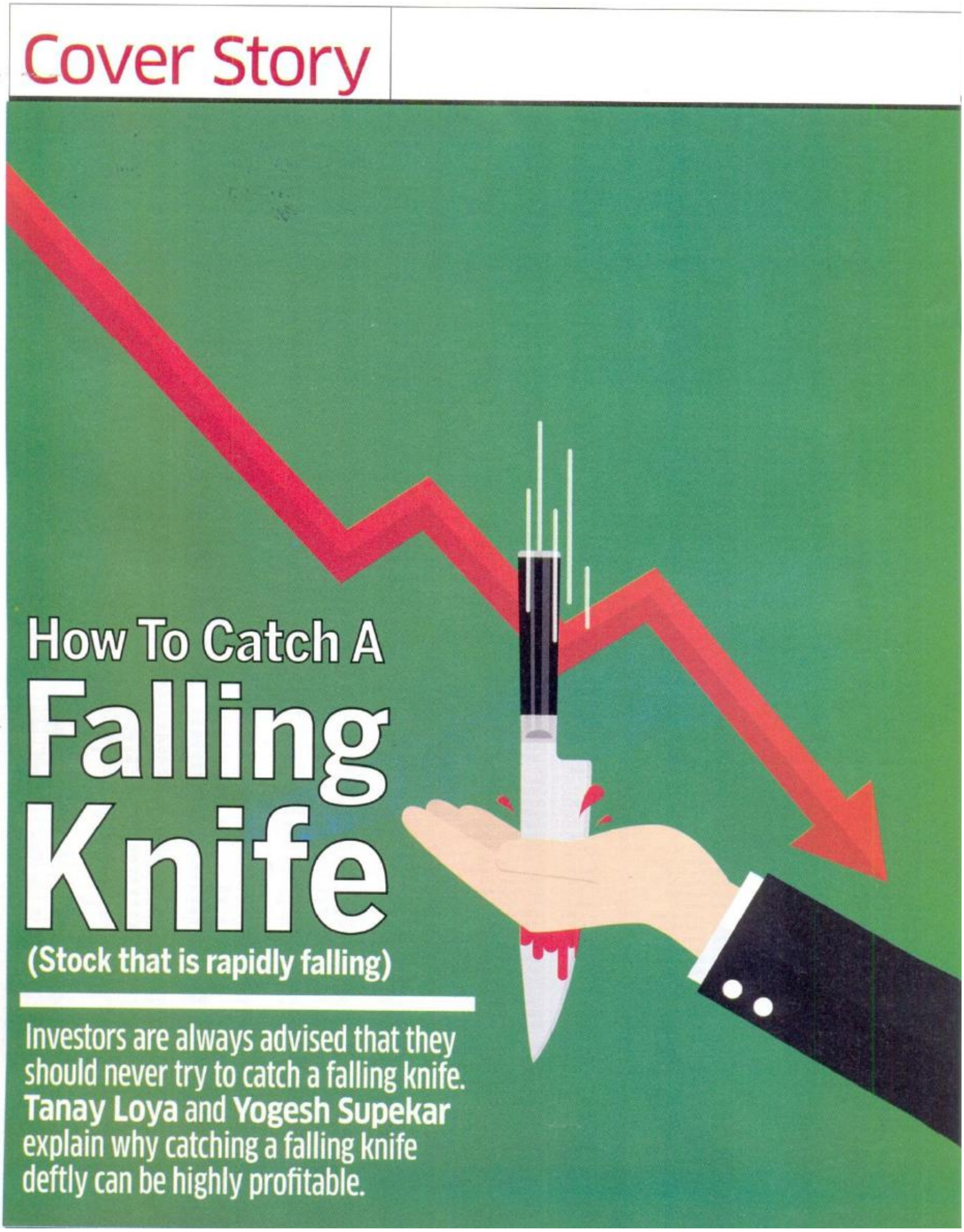

Cover Story

How To Catch A Falling Knife

(Stock that is rapidly falling)

Investors are always advised that they should never try to catch a falling knife. **Tanay Loya** and **Yogesh Supekar** explain why catching a falling knife deftly can be highly profitable.

What is "Catching of Falling Knife?"

A security which shows a steep decline with virtually no counter movement on its way down is called a 'falling knife'. There could be many reasons which lead to this phenomenon. The earnings report could be one of the reasons as companies that report earnings are subject to volatile swings. If the earnings are lower than expected, then the stock might turn into a falling knife. Economic reports also influence the prices of shares, which could sharply fall in response to negative reports. The stocks could be falling at an accelerated rate right before a bankruptcy or after a horrible earnings report. Some falling knives can be an effect of technical breakdown rather than fundamental factors. Sectoral or legal issues, investors' sentiments or some other negative triggers could result in a decline in stock prices.

Investors are well aware of the clichéd advice: "Never catch the falling knife". But in spite of this well-known phrase in the stock market, we find that several investors never give up on catching the falling knife. In other words, investors keep on hunting for stocks that have witnessed a drastic fall in their prices, thinking that these stocks will eventually rise and deliver superior returns.

Why do investors attempt to catch the falling knife and is it worth it? But how does one go about this whole business of catching the falling knife and is there any strategy that can be adopted to clinically perform the act, resulting in superior returns? We will explore these common issues faced by the investors in this article.

Why do investors catch a falling knife?

It is a well-established fact that equity markets are fundamentally unpredictable. In spite of this overwhelming historical evidence, we find that investors attempt to predict prices, both in the near term as well as in the long term.

The best among the fund managers and equity analysts, using their market intelligence and research capabilities, can estimate profitability and earnings only for a few quarters ahead. It is very difficult to accurately predict profits of a company 5 years or 10 years down the line.

Most of the investors err on the fact that they start believing that they have superior predictive ability. Investors are under the impression that they know more than the majority when it comes to the stock they are invested in. Majority of the investors focus on the stock prices and tend to believe that the stocks are available at discounted prices and hence end up catching the falling knives.

Sagar Nimbalkar, a savvy investor, says, "There are many instances in my portfolio when I bought stocks that have fallen by 50 per cent or more – only to find that the shares have further fallen 50 per cent from my purchase price. I realised my mistake – I used to be focused on stock prices more than anything else, and worked on the assumption that the stock that has fallen by 50 per cent from its high is available at a discount.

I don't make such mistakes anymore. However, that doesn't mean I don't attempt to catch the falling knives at all."

> **"A stock declines for multiple reasons, including poor quarterly results, sectoral issues, corporate governance issue, negative market sentiments, legal issues and many more contingent negative triggers."**

The lure of extraordinary returns, the perception that the stock that has fallen by more than 50 per cent is cheap and the wrong notion that "I know everything about the falling stock" are some of the clear reasons that tempt the investors to catch the falling knife. Investors frequently believe that most of the negatives are factored in and that only positive news will flow for the stock they are invested in. There is "hope" instead of "analysis" that drives the investors' expectations and that is where things go wrong.

According to Nobel Prize winning psychologist Daniel Kahnemann, investors are very much attracted to a falling knife due to some cluster of fundamental human traits. In his book "Thinking Fast and Slow" he has explained in detail his observations taking into account 50 years of investor behaviour. He finds that investors act based on intuition more than rational thinking when the prices move in either direction rapidly. When the stock prices fall rapidly, investors take quick action on these stocks, driven by intuition when the need to the hour is to go slow and analyse the facts.

Nooresh
Technical Analyst

"Just as traders go bust after making big mistakes, investors get lost for a long time after seeing a big crack in their portfolios."

Why catch a falling knife?

Markets can be irrational in the short term – both when it is heading up or when it nosedives. The tendency of the market is to deviate from its true value or intrinsic value at least in the short run. When the market sentiment is negative or any bad news impacts the stock prices, it is often seen that heavy selling in the counter brings down the stock prices more than required. It is quite possible that the fallen stock trades at 25 to 50 per cent discount to its intrinsic value. A falling knife will always provide investing opportunities for those who can analyse the market situation and the individual stocks.

How best to catch a falling knife ?

Let us say there is a situation in the equity markets where there are several falling knives available for investors to choose from. Usually, when the markets are in correction mode, one may find several such stocks crashing 20 per cent to 50 per cent or even more. At times in a bear markets, the benchmark index itself becomes a falling knife.

Such instances provide excellent opportunities for both traders and investors to exercise their market timing skills. Howsoever adventurous the exercise may be, there is always a chance of making a killing in such times.

Points to remember while trying to catch a falling knife :-

- The outcome of catching the falling knife can be extreme on either side. Any investor or trader should factor in such possibilities and should not be surprised if the stock falls further by 20 to 50 per cent.

Margin of Safety

Margin of Safety refers to a buying a stock at price which is far below than its intrinsic or true value.

"When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000 pound trucks across it. And that same principle works in investing."

Warren Buffet

"A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world."

Seth Klarman
President and CEO, Baupost Group

- Analyse why the stock has fallen so much and whether the situation is expected to change for the better for the stock. Understand the concept of margin of safety and attempt to apply the concept in such a situation. If a margin of safety is visible, go ahead and invest in the falling knife.

Performance of stocks that have fallen more than 40 per cent in less than 1 year

If we consider the historical data and understand the kind of performance we can expect from bottom-fishing in those stocks that have gone down by more than 40 per cent in the same year, we find their performance as given below :-

1, 2 and 3 Years average returns for those stocks that have fallen more than 40 per cent.

Year	1 year	2 Yrs	3 Yrs
2014	80	50	50
2015	60	51	35
2016	91	58	--

Returns for 2 and 3 years are annualised

These are the rewards one can get for catching a falling knife right when it hits the bottom price, which is almost impossible to do consistently. However, the data highlights the potential returns of catching a falling knife accurately.

Nitesh Khandelwal

CEO, QuanInsti - Leading pioneer Algorithmic Trading Research and Training Institute.

The phrase 'Catching a falling knife' is a popular one in financial markets. As the phrase suggests, it refers to buying a stock that has been falling rapidly. Many investors get wildly attracted towards the stocks whose prices have dropped sharply or have gone way below their previous high. There is a good reason for that attraction! Amazon was one such falling knife during the dot-com crash, with its stock price crashing from $107 to about $6 in less than two years. Over the next one-and-half decade though, it went on to increase by more than 250 times! This and few other similar stories can tempt anyone. But, there are far too many untold stories of stocks that witnessed such steep falls without any spectacular rebound and got lost in the shadows of bankruptcies.

As any seasoned long-term investor might tell you that any price crash in a stock with strong fundamentals may be a good investment opportunity. The top investors/funds that have been able to benefit from investing in battered stocks kept focus on the quality and strong fundamentals of the company. The key differentiating factor for them has been the research. In fact, the new age investors have even started to deploy machines to do that research, helping them in covering a much wider universe of stocks and using statistically advanced techniques, including machine learning, to produce high quality research to test the fundamentals quantitatively, i.e. quantitative value investing. There are ample screeners available today on the internet that can help you clear the chaff from the stock universe. You can filter the stocks based on the P/E, EPS, insider ownership changes, etc, helping you to map the quantum of fall with the appropriate reason that triggered it and evaluate if it is worth catching that falling knife.

So, can you profit from blindly investing in stocks that are rapidly falling? Mostly no. If you are doing your research right and employing tested methodologies for your research, then I would give a cautionary 'Yes'!

> "Historically, the stock market usually overreacts, and hence, catching a falling knife can be a profitable investment."

- Use appropriately the technical indicators such as oscillators and candlesticks to understand if the stock is oversold. Also give adequate importance to volumes while identifying the oversold stock.

- Maturity is required on the investor's part to diagnose whether the falling price trend is for the short-term or the long-term. A distinction needs to be done between the short-term and long-term trends and only then should one attempt to touch the falling knife.
- Do some sectoral analysis and study what various analysts and fund managers are saying about the prospects of the sector. Get deeper understanding of the challenges faced by the sector and what are the probable positives and negatives that can emerge for the sector. When you are sure of the industry prospects, only then should you go ahead and invest in the stock that has fallen sharply.

- Adopt diversification in this strategy as well. The trick is to identify five to ten such stocks that are falling or have fallen sharply. The portfolio approach for such stocks should help investors fare better than investing a huge amount in a single falling knife. In the portfolio, it may happen that couple of stocks fizzle out further and get closer to zero in prices, while few other stocks don't move at all, whereas few others generate more than 100 per cent returns, thus pushing the portfolio returns higher.

- Avoid averaging in the falling knives as it can kill the performance of the portfolio. Data suggest that retail investors have been accumulating stocks steadily even as the prices of select shares are continuously falling over the years. For example, the number of shareholders and number of shares have increased in Sun Pharma, Lupin , Suzlon , Kingfisher Airlines , Reliance Power, etc. even while the prices of these shares have fallen consistently over the years. This suggests that averaging has been done by individual investors and it has impacted portfolio performance for several investors.

Evidence of averaging and catching falling knife

- In Jaypee Infratech, the total number of public shareholders increased by 11.42 per cent between Dec-11 quarter and June-18 quarter, whereas its share price nosedived over 90 per cent.
- In case of Suzlon Energy, the total number of public shareholders increased by 4.66 per cent between Dec-12 and June-18 quarter, whereas its share price tumbled over 62 per cent.
- The individual shareholding almost doubled in Kingfisher Airlines between 2011 and 2013, even as the stock fell almost 90 per cent during the period.
- The number of shareholders almost doubled and the number of shares were 50 per cent higher for Lupin when the stock steadily fell down by 50 per cent since 2015.

Conclusion

For an individual investor, there is more to catching the falling knife than simply beating key benchmark indices.

Investors take this adventurous step mostly intuitively without researching the company prospects properly and do it with the hope of generating abnormal returns. The idea that the stock has fallen from ₹100 to ₹10 and if they invest in this stock at ₹10, they may more than double their money, excites a majority of investors.

The returns on investments while catching a falling knife may not be linear, that is, the returns could be aggressive. However the odds of making money on such investments could be very low.

If normal stock picking requires a good understanding of the fundamental analysis and how the market works, investing in a falling knife will definitely require deeper insights and accurate analysis of the sector and the markets.

Timing will be crucial and will have to be immaculate. Such investing practice will require perfect market timing skills and may require support of technical analysis. There is always a chance to make money in a strategy involving investing in a falling knife, assuming that the margin of safety is estimated and the intrinsic value is more than the stock price one is investing in.

Needless to say, this strategy is more suited for the aggressive investor looking to generate above average returns and is definitely not suitable for the conservative and passive investor. Catching a falling knife is similar to any other stock investing, except that the timing element is the most crucial in this strategy. Any investor willing to adopt this strategy has to work on market timing skills. Specific market timing skills can be developed and honed if one is keen to work on this strategy for the long term.