BAD NEWS AND PRICE DISASTERS: AVOIDING, RESPONDING, COPING

By Donald L. Cassidy

While FDA denials, post-merger indigestion write-offs, product delays, and occasional accounting frauds do drop stock prices harshly, by far the most frequent culprit is an earnings disappointment, while the next most common is an earnings or growth-rate warning.

Over several years I've provided individual investors with one major formula for identifying high risk of sudden loss:

  High technology
\+ High P/E (or High PEG)
\+ High growth
\+ High expectations
\+ High institutional ownership
= High risk of sudden loss

The various components seem to rotate in importance over time.

Clearly, from March through May, technology (including biotechnology) was the key to sharp losses. But take no false comfort if you own no tech stocks: Edison International, Amazon, Starbucks, Dillard's, and even AT&T have been among dozens in other industries to fall comparably far and fast. Institutional ownership (to be discussed later) remains a constant and seemingly rising danger factor. With recent signs of a slowing economy, the combination of high growth and, particularly, high expectations, will likely become a more frequent danger driver as downside earnings per share "surprises" mount.

In this article, I'll dissect the causes and dynamics of bad-news reactions, discuss strategies and tactics for avoiding such events, and examine ways to respond and cope when disaster has already struck.

BAD-NEWS REACTIONS

In any area of life, the higher one's expectations are, the more severe is the disappointment upon failure.

On Wall Street, sell-side analysts have become cheerleaders. Business Week recently ran a cover calling the whole practice "the hype machine;" the Wall Street Journal ran a chronicle of one analyst's sequence of rising target prices for Cisco, most of which were set without new bullish fundamentals having prompted the new price.

Often, earnings per share consensus forecasts and "whispers" (unofficial earnings estimates) get out of hand on the upside, as players seek to justify past price rises. This game is a major creator of potential price calamity. Fine companies, even industry leaders, are not automatically a bargain at any price. Given their underlying businesses and growth rates, how could one truly justify paying over 40 times earnings for Procter & Gamble, or 60 times earnings for Starbucks, before their earnings stumbles?

We've gone since 1991 without a recession; expectations largely exclude such a possibility, and millions of investors have never been in the market through one.

Psychologists' experiments and actual market-price responses both prove that fear is a much stronger driver than greed. Immediate worldwide trans-

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mission and absorption of news (and resulting opinion) has compressed market reaction time and probably accentuated percentage losses in recent years. Scary price drops alone engender added selling. All of this means the degree of risk to your money has risen.

Once bad news has caused a sharp price collapse, the very vividness of that decline causes more fear, and revulsion against the stock sets in. No one dares touch it. Any modest rally finds sellers who seek to marginally reduce their losses and pain. Failed rallies then uncover additional discouraged sellers. In a high-expectations market, the damaged stock is "off limits" to professionals for a period of months. The company needs time to rebuild supporters even if it never misled street opinion. As a result, if you were to look at short-term stock prices, the chart pattern would resemble a lazy "L," with a long horizontal blade following the day of collapse (as illustrated in the price chart for Circuit City in Figure 1). This typical pattern implies certain actions, to be discussed below.

AVOIDING SUDDEN DEBACLES

It is not possible to anticipate all possible market situations, but there are some prudent preventive measures that can help steer the wary and nimble out of harm's way quite often.

Be aware, however, that signs of an economic deceleration (or worse) have raised the number of companies and industries likely to present disappointments. In addition, price volatility is up in the instant-information/instant-reaction era, and likely will remain high at least until a bear market flushes out the last vestiges of speculation. That doesn't mean that I am predicting a bear market, but rather I am merely providing a behaviorally-based prediction on volatility until such occurs.

How volatile are stocks? Looking only at the relatively stable over-$5 population of stocks on the New York Stock Exchange and excluding the roughly 400 closed-end funds listed there, for the period 1990 through 1999 the average stock had 11% earnings growth per year (albeit not smooth!), but had a 65% annual price range from bottom to top. Thus, emotions moved stocks six times as widely as fundamentals justified. Most investors usually underestimate the violence of price moves.

While FDA denials, post-merger indigestion write-offs, product delays, and occasional accounting frauds do drop stock prices harshly, by far the most frequent culprit is an earnings disappointment. The next most common is an earnings or growth-rate warning. Therefore, holders of stocks must know what date earnings per share are to be released. Many databases provide guidance, as does looking up the prior year's news items' dates. The easiest path is to phone the company and ask. Also, learn whether management has a policy of providing warnings, or if it never comments until its actual earnings per share release date. Warnings come in the final month of the fiscal quarter or right after it closes. Those dates are danger zones on your calendar.

You should also know the percentage of the stock, or the float, held by institutions. The higher it is, the greater the price risk if anything is amiss.

When I am being especially cautious, I will not hold a stock with large institutional exposure through its warning or earnings per share reporting date. However, this advice admittedly flies in the face of long-term buy-and-hold principles, and will clearly raise transaction costs. In my mind, however, the risk is simply too great, and today's minuscule commissions make stepping aside cheap insurance. Positive surprises are few and generate only a small upside reward, which is usually fleeting, while a disappointment typically drives a 25%–50% overnight loss.

When you are smart or fortunate enough to own a stock that has risen on a takeover announcement, you would also be wise not to hold it until the final event to capture the last few possible percents, especially in cash deals where a tax effect is inevitable. If the planned merger comes apart, your loss will show that the risk/reward ratio was much too high. Worldcom/Sprint is a recent example. Financing failure of the proposed leveraged buyout of UAL in 1987 was cited as a psychological trigger that may have led to, or speeded up, that October's meltdown. As in all aspects of investing, you get paid to anticipate rather than to react afterward.

You should also be aware of special market mechanics that can trigger or exacerbate price declines and that very often limit recoveries. First, big price declines, especially if the stock had declined somewhat before the bad event, cause margin calls. In Internet-traders' favorite issues, this adds to price declines on the second and following days. Similarly, if a recent initial public offering falls below its original issue price, holders typically will panic and add to the price pressure. Such situations should help you prune your at-risk list, or at least consider using stop-loss (but not stop-limit) orders.

If you do use a stop order, use regular stops only, and be aware of their limitations. They will help you only if the bad news and price collapse starts during a trading session; if the negative event is announced post-close and drives a gap-down opening, they will ensure that you are out at a disastrously low price. For example, if your stock closed at 60, your stop was at 58, and the bad news occurs after close and the stock re-opens at 40, you do not get 58, you get 40. So you need to know when earnings per share news is coming, and you must

FIGURE 1. PRICE CHART FOR CIRCUIT CITY

Source: MetaStock by Equis International.

monitor all stop orders overnight. On a very short-term basis, the opening price after a news shocker is usually not the best of the day.

HOW TO RESPOND

Once Day 1's price damage is a fact, you can at least prevent your loss from becoming worse with some careful thinking.

First, you must analyze the nature of the bad news and its market context. The answers will point to a likely future price direction. Analyzing the news in terms of true importance, not just its price-shock impact, is your key to making a hold/sell decision.

Different kinds of bad news have graded price effects. News that undermines corporate credibility (and especially viability) causes ongoing price erosion and takes lengthy repair time. Accounting scandals at Rite Aid and, previously, Cendant are examples. In these situations, getting out early is almost always best.

A product failure implying technological weakness or competitive defeat also carries serious long-term implications.

Less critical is a minor earnings shortfall, especially if caused by one-time factors—slow business in the first quarter of 2000 after fourth-quarter 1999 stockpiling for Y2K is an example. But bad earnings in the midst of prosperity for competitors would be a danger sign.

Another important issue is whether the bad news is predictably the start of a sequence. Once Microsoft was served anti-trust papers by Washington, one could see a long workout period before a resolution. Remember, the market hates uncertainty.

In addition, even if your analysis indicates a fairly trivial and transient problem, the market climate is an important factor. Through 1998, stocks of companies with bad news and price gaps tended to recover within six months in over 80% of cases. In contrast, since early 1999, quick forgiveness has been rare in a climate where the cumulative advance/decline line has been falling, in which some would call a bear market. In a negatively inclined market, what looks like a fundamental bargain may remain such for an extended period as investors seek low perceived risk in unblemished situations.

WHAT TO DO

In assessing what to do, try to be dispassionate, even though you may be hurting from the financial damage incurred. Ask whether, as an objective non-holder, you would actually buy this stock right now for a rebound. If not, you are predicting the mindset of the majority, so the

stock is likely to do no better than tread water for some time.

The choices you face will be whether to hold, sell or even buy more. If your analysis indicates a sale is most prudent, you might actually need to stand a little more heat before getting price relief. A study I did in 1998, covering nearly 200 downside gaps, showed that under 30% of the drops hit bottom on Day 1, but 91% had done so by Day 5. So, unless you smell a fraud or looming bankruptcy, try to hold on for a week-plus, and better prices will likely become available. Day 1 brings by far the greatest percentage loss, illustrated again by Circuit City in Figure 1.

If you decide to hold, remember that thousands of others are in your same position. Do not expect any major rally, since price improvement will attract sellers relieved to be able to lessen their pain. Those who did sell on Day 1 are now governed by the 31-day wash-sale tax rule, so they will stand aside as bargain hunters for a month. Equal patience by you is implied.

Finally, if your impulse is to buy more due to the "bargain" available, lean heavily toward patience. An old Wall Street adage says the first trouble is usually not the last. Besides, there really is no rush, as other investors in large numbers must regain their confidence before the stock will garner enough support for a major recovery.

When trying to decide what to do, be aware of calendar patterns. If calendar quarter-end is approaching, be especially patient: Window-dressing will keep the stock on clearance lists and off urgent-buy lists. Likewise, if December is nearby, tax-selling pressure will weigh on the price, so the bargain of today may become even cheaper. However, the start of the new quarter, and year, often relieves such pressures and a worthwhile rally can then occur. April 1 in 2000 was a rally starter for Procter & Gamble.

LONG-TERM COPING

The most important coping mechanism you can implement is to change your investment behavior in response to a lesson painfully learned. Investing success requires proper action by both the instrument (stock, bond, or fund) and its holder (you). Therefore, it is important to look realistically at your emotional toughness under adversity: Do you have a hard time admitting mistakes?

You should also look critically at your portfolio. How many other at-risk situations do you own? Could you stand it, emotionally or dollar-wise, if more lightning bolts hit?

Diagnose your holdings for the elements of risk listed here. Your misfortune was not a random stroke of bad luck; it occurred where risk actually was high based on the factors listed in my equation. Perhaps you should own fewer high-flyers and institutional favorites. Maybe you should own more mutual funds and fewer individual stocks, thus reducing your odds of another very painful experience.

In short, profit from your mistakes. It would be a shame to pay the high tuition and not have learned anything. ✦