# WHAT STEPS YOU SHOULD TAKE WHEN YOUR STOCK'S PRICE FALLS

By Wayne A. Thorp

There are no simple rules that will tell you when to sell a stock, but an in-depth understanding of what economic, industry, and firm fundamentals drive the price of your stock will better equip you in determining whether the time has come to sell your stake.

In investing there are a few universal truths. One of them is that at some point, a stock's price will fall. There are a myriad of reasons why a stock's price falls and it is up to you to determine the cause. By identifying why the price is falling, you are far better equipped to decide if it is time to sell your position or if the fall in value presents an opportunity to purchase additional shares. The key is neither to react every time a stock you own dips, nor to become so emotionally attached to an investment that you stay with it no matter what the news.

## THE KEY: FUNDAMENTALS

The decision to sell a stock should be similar to the decision to buy a stock. But the price paid for a stock must be put aside when deciding if it is time to sell. The sell decision should focus on a company's future prospects and fundamentals relative to its current stock price. If the reasons for buying the company—i.e., its fundamentals—have not changed, then there may be no reason to sell. Many investors lose sight of this and allow their emotions to dictate their sell decisions.

When you look at stocks that are declining in price, often you will find recurring themes that, once identified, can help you decide what your next step should be. These themes are typically related to one of three things: market movement as a whole, industry action in which the firm operates, or firm-specific issues. In this article, we will discuss some of these themes and the steps investors can take in the face of events. Be mindful, however, that it is not always apparent that the fundamentals of a company have changed. The key is to understand what is driving the price of the stock. If you are not able to identify why the price is falling, perhaps it is best for you to exit your position.

## MARKET WEAKNESS

Weakness in the overall market, by itself, is never a good reason to sell your stocks. Markets rise and fall, but history has shown that over the long term a well-diversified portfolio of stocks will not only generate a positive return, but also provide the best opportunity for providing a return above the rate of inflation. It is important to keep your investment horizon in mind—long-term investors should not be deterred by short-term declines.

It is a good idea, however, to compare the performance of an individual stock to that of the overall market. One of the main goals of investing in individual stocks is to achieve returns above those of the overall market for a given level of risk. Most stocks react to market moves in a consistent pattern. Further investigation is warranted if the price movement of a stock suddenly starts to deviate from its past relationship with the market or related index. Even if the company appears to be in the same condition as it was when you bought it, a lagging stock price in relation to the overall market may mean that there is a group of investors that believe that the stock's fundamentals have changed. In this situation, you might consider liquidating your position

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instead of waiting for information to surface.

## INDUSTRY CONSIDERATIONS

Just as the market as a whole can have a bearing on an individual stock's price, so too can the industry in which the firm operates. A downturn in a stock can be attributed to the cyclical nature of its industry, a long-term secular trend, structural weakness within the industry, government regulation of the industry, or liability issues facing the industry.

### Stock Prices and Industry Cycles

All industries, to some extent, have a pattern to their movement. Most industries follow a seasonal pattern, with sales stronger in some portion of the year. Economic cycles are even more pronounced and longer lasting. Some industries move in tandem with the economy—rising as the economy expands and falling when it contracts—while others are counter-cyclical, meaning they move in the opposite direction of the economy as a whole. Factors such as interest rates, production levels, material costs, labor availability and costs, and consumer sentiment fluctuate over the course of an economic cycle and they impact various industries differently.

No matter what the cycle, you should not sell a stock just because its industry has entered into the decline portion of a cycle. As a long-term investor, you should be aware of any cyclical behavior in a stock's industry before you buy the stock, and you should be prepared to hold the stock through the upward as well as the downward portions of the cycle, perhaps even adding to a position at cyclical lows.

### Structural Changes in an Industry

There are times when a decline in the overall industry signals a time for you to sell your shares. One such example involves structural changes within the industry. Structural considerations, as the name implies, strike at the very heart of the industry and ultimately can determine its survival or failure. Structural changes can be brought about by several things, including technology and competition. One example is the decline of the traditional American steel industry due to the growth of mini-mills and increased foreign competition.

Companies within industries faced with structural changes will more than likely see some change in their fundamentals. The extent of the impact, as well as the industry's and company's ability to adapt, will determine whether the time has come to sell.

### Regulatory Changes

Government regulation can take many forms and can have differing impacts on the stock performance of companies in the industry. The government can impose limits on how much companies can pollute or dictate how much a company can charge for their product or even how profitable a company can be.

For investors, the concern should revolve around changes in regulations that could come from the federal, state, or local level. You should be mindful when the government steps in to impose regulations on a previously unregulated industry, or steps up or changes regulatory rules. If the regulation imposes additional costs on firms within the industry, then the impact will probably be negative, as the cost structures of the firms within the industry change. On the other hand, added rules may raise the costs of entry into the industry high enough to limit potential competitors, in which case the existing firms that are able to operate under the new rules may benefit from the lack of competition.

While government regulation of an industry can have an impact on the companies within the industry, the trend in recent years has been toward government *deregulation*, which will also have an impact—typically positive for companies, but potentially negative as well. One negative example that stands out is the utility industry, which began deregulation in the late 1990s. In California, utilities lost the protections that government regulation afforded them, including limited competition and guaranteed return on investments.

### Industry Liability Issues

In recent years, high-profile liability cases against certain industries have garnered a great deal of media interest. Two industries targeted by such suits have been the tobacco industry and the asbestos products industry, although the impact on the two has been very different. Both industries are facing a mountain of litigation due to the health problems their respective products have now been identified as causing. The tobacco industry has settled a number of these suits at a cost of billions of dollars. Shifts in investor perceptions regarding the risk of future litigation and additional government regulation has led to significant periods of relative underperformance and outperformance over the years. The asbestos issue, in contrast, has crippled numerous companies, with many filing for bankruptcy.

As these two examples show, you should not immediately sell your stock just because an industry is suddenly faced with legal action. Instead, you should do some homework to try to determine the validity of the suit as well as the ultimate impact it could have on the companies within the industry. Investor perception is important, so you should not lose sight of the possible market reaction or overreaction of these litigation issues when doing your research.

### Competitor Announcements

Companies do not operate in a vacuum, and what happens to one company can impact those around them, especially those that are competitors. Announcements from a company that deal with overall

industry conditions will, to some extent, have an impact on its competitors. When a company issues a warning regarding its operations, the first thing an investor should do is discern if the problem is unique to the company or is an industry-wide problem. Bad news that points to a weakness in the overall market or industry does not bode well for other companies that are in that same industry.

Understanding the product or service provided by the company you own will help you determine how news from a competitor will impact its stock price. If the company provides a "commodity" product or service—meaning that the product or service is interchangeable or easily substituted with another company's product or service—then bad news from a company that is related to market or industry conditions probably won't bode well for the other companies in the industry. Examples of companies providing commodity products are steel, paper, and even memory chip producers.

On the other hand, a company has a "franchise" when its products or services are special or unique in comparison to those provided by the competition. Companies that fall into this category tend to be better insulated from negative announcements coming from competitors.

Investors should also be mindful of *good news* coming from the competition. If the industry as a whole is doing well, there is probably little reason to be worried. However, if a competitor is increasing market share at the expense of other companies in the industry, this is a cause for concern. Wal-Mart's desire to open more stores may not be good news for a more troubled discounter such as K-Mart, or even a high-end retailer such as Nordstrom, which would probably be hit more severely than Wal-Mart during an economic slowdown.

## FIRM-SPECIFIC ISSUES

Having touched on issues relating to the market as a whole as well as the industry, we now come to the last point of consideration, the firm itself. Though the scope has narrowed, the issues to consider are broader. These can include earnings, management, liability, government regulation, competition, and fraud.

### What do I do when a "disaster" befalls a company?

Through the course of normal business operations, companies can be stricken by extraordinary events—natural disasters, product recalls, and specific product liability suits, for example. The common response of investors to such events is to sell without taking a rational look at what has really happened. This forces stock prices down—often significantly—in a short period of time.

When confronted by this type of reactionary selling, investors need to look past the noise and address a singular issue: Are the *fundamentals* of the company different than they were before the event? If the answer is no, meaning there is no indication that the company will be unable to generate earnings and operate in the same manner as it has been, there is no reason to sell. In fact, the fall in price may represent an opportunity to buy more of the stock at a discount. However, if management negligence led to the disaster, or if the earnings-generating potential of the firm has been impaired, the prudent move might be to sell.

It is also beneficial to consider the "disaster" in a broader context. Sometimes events such as a product recall are indicative of underlying problems within the company that could grow to even bigger problems down the road. In these cases, the best course of action would be to sell. Other times, however, such events have a short-lived, temporary impact and you are usually better off holding or even adding to your position.

The size of the company and the nature of its business also play a role in how easily a company can recover from such events. Larger, more established companies with stable earnings are better positioned to handle these situations, as are companies whose products or services are not easily substituted by the products or services of other companies. Smaller firms, as well as growth companies, tend to experience stronger investor reaction when bad news hits, and subsequently these kinds of stocks take longer to recover. In general, the smaller the company, the less information that will be available for you to gain an understanding of the problem. If you still do not understand what has happened even after doing some additional investigation, you should sell the stock.

### Should I sell just because a company falls short of its consensus earnings estimate figure?

Each quarter investors anxiously await company earnings announcements, which will meet, exceed, or fall short of analysts' expectations. When companies fail to meet expectations, investor reaction is dictated to a large extent by how large the "miss" is.

When the shortfall is "small," the impact probably won't be significant enough to warrant a mass sell-off or large decline in price. However, if the company has a history of *exceeding* analyst estimates and then suddenly misses the mark, this could signal future troubles for the company. No matter how small the shortfall, you may wish to investigate the reasons behind it to try to identify any problems that may be looming.

The larger the earnings shortfall as compared to expected earnings, the more negative investor reaction tends to become, and the ensuing price declines grow as well. This is especially true for momentum stocks that have had a string of positive earnings surprises. History has shown that once these stocks have one negative earnings surprise, the

decline can be swift and massive. In cases like this, your best bet is to sell as quickly as possible.

There are those cases when a company may announce earnings in excess of the consensus estimate and, at the same time, warn that they may not be able to meet expectations for the next fiscal quarter. This is known as "downward guidance" and is not necessarily as bad as it sounds. Over the years, companies have become very adept at managing analyst and investor expectations. Downward guidance is a way for a company to provide advance warning so that market analysts are not taken by surprise if an earnings shortfall takes place. When a company provides downward guidance, analysts tend to lower their earnings estimates and, in doing so, make it easier for a company to make or exceed these lowered expectations. You should, however, examine the root causes of the expected shortfall to see if there are bigger problems brewing at the company.

### Should I be concerned with changes in company management?

With all companies, there will be changes in top management from time to time as people retire or move on to different firms. The majority of times these moves are amicable and will have no lasting impact on the company. Well-run companies will have people in place to assume these vacancies or can recruit from the outside.

There are the rare occasions, however, when the departure of one or more members of top management can signal serious problems. A mass exodus of top management is one example. Sometimes, news will begin surfacing as to deep-rooted problems within the company—sometimes rooted in accounting fraud by those who have recently departed.

Another potential area of concern is when a key member of the top management unexpectedly leaves. While it may be that the person was simply offered a better position elsewhere, you will want to stay alert for any news that may come from the company signaling bigger problems.

### A company has just changed auditors, again. Should this worry me?

Auditors examine and verify the validity of company financial and accounting records. They strive to make sure the information is as accurate as possible.

When a company changes auditors, therefore, it is not always an innocuous event, especially if the company has a history of changing auditors. Many times, these companies are trying to use questionable accounting practices that the auditor will not go along with. Eventually these companies are found out and their stock prices suffer accordingly.

### A company announces it is buying another company and the price drops. Should I sell?

When one company announces it is buying another, the typical market reaction is to drive down the price of the buyer and to drive up the price of the firm being acquired. The reasoning is usually that the acquirer is thought to be paying too much or the acquisition does not hold promise. Depending on the companies involved, there may be questions of whether the merger will be allowed to take place from a regulatory angle, whether the corporate cultures are compatible, and whether there will be a dilution of earnings.

You can attempt to learn more about the merger and try to discern for yourself whether or not it will benefit investors. However, information tends to be sparse and can be less than objective. The main source of information is often the management of the acquiring firm, and they will only be lauding the acquisition.

Analysts may also make their opinions known, but you need to discount this information if the analyst works for a brokerage firm who has investment banking ties to the deal.

### Should I sell a stock that was doing well but has been declining for the past few weeks?

All stocks will eventually have a price decline. It is normal for a stock that has been rising for an extended period of time to take a breather now and then and take a dip. As long as there is no news that accompanies this decline, investors may wish to use these short-term declines to add to their position.

When looking at a fall in stock price, especially after a prolonged run-up, you should examine the decline in relation to the industry, as well as the trading volume accompanying the decline. If the stock declines significantly versus the industry or if there is above-average volume as the price falls, you may want to consider selling the position. However, if the stock is down on average volume, you may want to buy additional shares. The key, again, is whether the fundamentals of the company have changed.

### What should I do if the stock price has been declining for a long period for no apparent reason?

No investor likes to see the value of his or her shares decline over a long period, especially if there appears to be no contributing factor(s) to the decline. As prices decline, there will be those investors who believe that the market as a whole is more knowledgeable than they are and enter into a "herd" mentality, selling their shares and further lowering the price. There are others who take a contrarian approach, believing that sellers are overreacting. Such investors will add to their positions as the price drops, taking advantage of what they believe to be a bargain price.

Most professional investors view a slow, steady decline in a stock's price as an excellent buying opportunity. Their reasoning is that if there were real problems with the com-

pany, the rush of investors to sell would force the price down sharply in a short amount of time. Instead, they theorize that declines in price are caused by money managers selling their stake in a company to raise money and this, in turn, causes some investors to follow suit.

## CONCLUSION

While this article has outlined the issues you should consider if your stock holding should fall in price, your own reaction to these situations will also have a big impact on the outcome. The biggest problem many investors face is that they become too emotionally involved and lose objectivity when deciding whether it is time to sell. Maintaining your objectivity during these times is important to your investing success.

Unfortunately, there are no simple, mechanical rules that are effective for when to sell a stock. Nothing substitutes for an understanding of what economic, industry, and firm fundamentals drive your stock's price.

By examining the situation rationally and doing your homework to determine if the fundamentals of the company have changed, you are better equipped to determine whether the time has come to sell your stake. ❖

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