

>: Catching Falling Knife Stocks? A Bloody Mistake!

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What is it about "catching the falling knife", the term that describes buying stocks or other investments when they have fallen considerably in price within a short period of time, that is so attractive to people?

I knew an "investor" once, and falling knife stocks were all that he bought! Usually it was some low priced tech company below \$5 a share. He felt that this made for a great bargain, and that in time he would be rewarded. Some times he was correct, but more often than not the stock would either languish for months or continue to fall in price.

Recently we have witnessed falling knives in homebuilder, financial, and retail stocks. Along the way, at various points, people have rushed in to buy these stocks, and then have been sorry.

Remember that for every seller there is a buyer. That means that someone bought Countrywide (CFC) at 20, at 15, at 10, and even at 5.12! Ouch!

It is not my intention to pick on any one particular stock. Other financial stocks like Washington Mutual (WM), Fannie Mae (FNM), retailers, such as Coach (COH), and restaurants such as Darden (DRI) have all been sliced in half by the knife. You will frequently hear that these stocks are a great buy at current beaten down levels. But that is often faulty logic.

We need to learn the lesson of the last bear market, 2000-2002. Tech stock companies that were cut from \$100 to \$20 were not great buys. They either went out of business, fell to 5 bucks a share, or took years and years to come back.

People say "buy ABC stock" at the current price, and it will be a great long term play. But what good is holding a stock for two years that will languish or go lower?

Personally, I would rather find another stock, like XYZ that goes up over that two year period, then when ABC looks like it has bottomed and begins to rise, I can take my profits from XYZ, and buy ABC.

Some people rush to be the first contrarian to buy the falling knife stock. I believe this is an ego trip that is antithetical to prudent investing strategy. Their desire may be to boast to others that they bought ABC stock 20 cents from the bottom, and then rode it up for a huge profit. But it seldom works out that way.

One thing to realize is that when a stock falls precipitously, there is tremendous resistance that is then established at the higher prices. All the people who bought WM at \$40 and \$35 and \$30 and \$15 are all pleading, "Just let me get back to even, Lord, and I promise I will sell!" So the climb back up from the current \$12.34 price could take a very long time.

So how do you know when the time is right to bottom fish on these beaten down stocks?

You will see improving technical indicators (MACD, RSI, etc), improving volume on up days, decreasing volume on down days, perhaps some insider buying and better news coming out. Analysts will begin to upgrade the stock. Key resistance levels will be taken out. The stock will rise above the 30, 50, and 200-day moving averages.

Of course, waiting for these things to develop means that you WILL NOT pick the exact bottom. But so what? If you wait to buy CFC at \$7 instead of \$4, and it goes to \$15, you may not make quite as much profit, but you will substantially reduce the risk of losing all or part of your money.

Remember, when a knife falls off a table, and hits the floor, it does not usually bounce up high. Instead, it usually dances and spins a little, then

again falls to the floor, where it remains for however long it takes before someone picks it up.

This analogy holds true for stocks as well.

So remember to be patient, and do not try to catch the falling knife, or you may find yourself with a cut and bleeding portfolio!

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