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Should you catch a falling knife?

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Abstract

After a share price slump, people often sense a favourable buying opportunity. But what are the chances of outperforming the market when catching a falling knife? Do different rules apply to quality companies?

Zusammenfassung

Nach einem Kurseinbruch einer Aktie wittert man häufig eine günstige Einstiegsmöglichkeit. Doch wie gut stehen die Chancen, den Markt zu schlagen, wenn man in ein fallendes Messer greift? Gelten bei Qualitätsunternehmen andere Regeln?

At the end of May, shares in the US software company Salesforce plummeted by 15 percent within one day. Is this a good opportunity to get in or buy more? Or are there fundamental problems with the company, so that you should get out or keep your hands off it?

But are the chances of generating an excess return by reaching for a falling knife really that bad? After all, you could also catch the handle. What are the characteristics of companies that manage to get a grip and return to their former greatness?

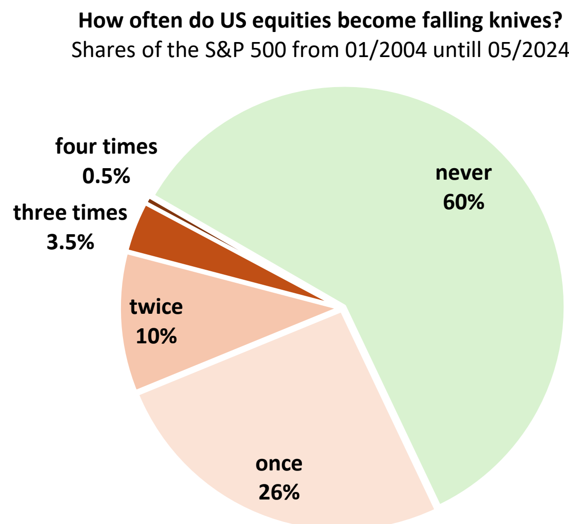
Falling knives on the US stock market

In this study, we define a falling knife as a share that suffers a price slump of 15% or more within five trading days. We look at US stocks that have been listed in the S&P 500 index in the last 20 years and did not fall below an inflation-adjusted market capitalization of EUR 7.5 billion before the crash.[1] If there is a series of slumps, we consider all slumps with less than two years between them as one event, as the causes could be related without us checking this in each individual case.

How often do shares become falling knives?

Price slumps are no exception for US equities. Of the 916 stocks analyzed, 40 percent (370 stocks) have fallen in the meantime. Of these, 26% were companies that only suffered a one-off slump, while the others were affected several times.

How often do US equities become falling knives?
Shares of the S&P 500 from 01/2004 untill 05/2024



916 US shares that were listed in the S&P 500 share index between 2004 and 2024. A "falling knife" is a price drop of 15% or more within 5 days. The periods of the financial, euro and coronavirus crises were excluded. Two price falls must be at least two years apart. Source: Calculations Flossbach von Storch Research Institute, Refinitiv, as at 04.06.2024

[1] The minimum size for the share to be taken into account is USD 7.5 billion in May 2024. This threshold is recalculated using the US consumer price index. In 2004, the threshold is thus reduced to USD 4.4 billion. Periods in which macroeconomic or political developments lead to an accumulation of share price falls, such as the financial, euro or coronavirus crisis, are not included in the analysis.

On average, share prices fell by 20 percent, in individual cases by as much as 60 percent. Of the 370 stocks affected, 35% were the result of a series of price falls, in which the falls were never more than two years apart. In two thirds of these cases, the share fell even further in a subsequent plunge.

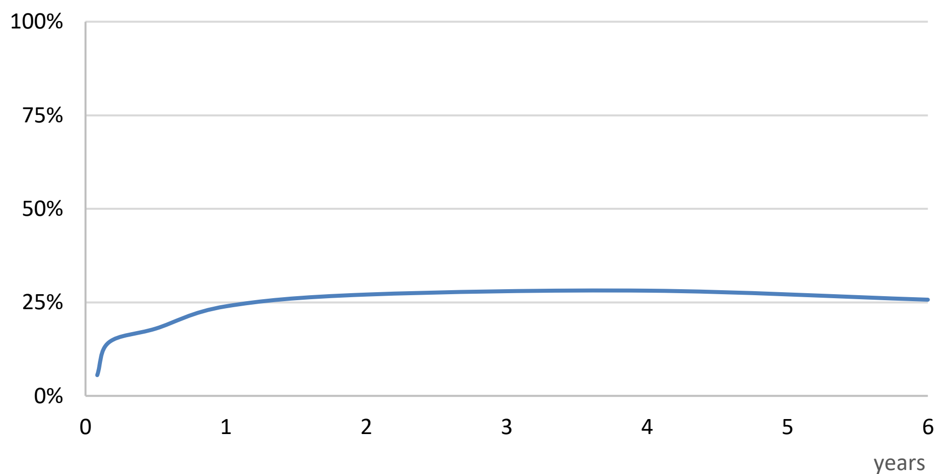
Is it worth catching a falling knife?

In the short term, this can work well if you manage to choose the right moment. In three quarters of the cases, investors who got in at the right time were able to outperform the S&P 500 within a month. However, performance deteriorated the longer the stocks were held and if the optimal time to enter the market was missed. After just one and a half years, more than half of the stocks were lagging behind the index. The outperformance was short-lived.

How many of the titles will come back up?

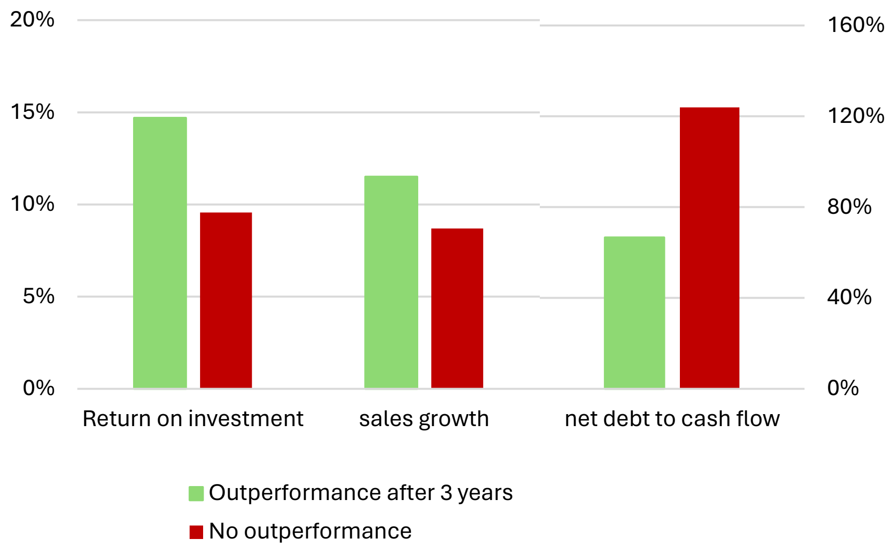
For investors who were already invested before the price drop and are hoping for a recovery, the picture is somewhat different. A recovery is understood to mean that a share has not only reached the price level before the fall, but has also been able to catch up on the market return that has accrued in the meantime.

One year after the price fall, only 24% of shares had recovered, compared with 28% after three years. A sustained recovery therefore appears to be the exception rather than the rule.



916 US shares that were listed in the S&P 500 share index between 2004 and 2024. A "falling knife" is a price drop of 15% or more within 5 days. The periods of the financial, euro and corona crises were excluded. A recovery occurs when the share has reached the price level of before the price drop at the given time and has also made up for the market return that has accrued in the meantime. Source: Calculations Flossbach von Storch Research Institute, Refinitiv, as at: 04.06.2024

Company fundamentals and outperformance



Return on investment is return on investment, sales growth is CAGR of sales for the past 5 years, net debt corresponds to net debt to free cash flow. Values correspond to the most recent quarterly figures when the share price fell. 547 observations. Source: Calculations Flossbach von Storch Research Institute, Refinitiv, as at 04.06.2024

Does the quality of the company play a role?

Quality companies are more likely to be able to recover from a fall in their share price. We measure company quality using the three characteristics of profitability (return on investment), growth (annualized sales growth) and debt (net debt in relation to free cash flow).

Stocks that have managed to both recover from the fall and catch up with market returns three years after the fall in share price have higher profitability, higher sales growth and lower debt at the time of the fall than the other cases.

If a quality company is defined as being in the top 25 percent of the annual cross-section in all three characteristics in a calendar year, the frequency of recovery after three years increases from the 28 percent described above to 39 percent.

Assessing the quality of a company can be helpful in estimating whether a share could recover from a price drop. The higher the quality, the more frequently a recovery is observed.

Lessons for investors

Reaching for the falling knife can pay off in the short term, but you have to grab it at the right time and let it go again in good time. While it is easy to see in hindsight when good entry and exit points would have been, it is extremely difficult to say without prior knowledge. In the long term, companies performed worse than the market after share price falls.

Investors who already own a share before it becomes a falling knife need to think carefully about whether they want to stick with it in the longer term and hope for a subsequent recovery. Even if you are convinced of the quality of a stock, you should fundamentally rethink your assessment of the price potential. Although quality companies recover from price falls more often than others in the long term, this is the exception rather than the rule for them too.

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