Insights

Falling Knives & Fallen Angels

Volatility in markets creates opportunities to buy the dip, but also presents new risks to be avoided!

Market volatility remains elevated, with ongoing concerns about inflation and weakness in the economy weighing on market sentiment. For the stock market, this means volatility is likely to continue and (to echo last week's episode) we probably have not yet seen the lows in this bear market for stocks.

Periods of market churn like we are currently living through typically punish speculators but can greatly reward the patient and long-term minded investor. When prices are falling, all else equal, the investment outlook for all investment opportunities has improved.

However there is a huge difference between a bad investment opportunity being less bad, because the price has come down, versus a high quality investment opportunity which is even more attractive now with a lower price.

An example from outside the stock market is probably useful now. Imagine first, an advertisement for a gambling website, or betting store, close to where you may live. One day a new offer is presented with an 80% reduction in the price of placing large bets. All else equal, this is a better offer than before, but this is still a bad investment even after the 80% reduction in price. It's a bet, plain and simple, it is risky and should be avoided, especially with large sums of ones savings or investment capital. These are our 'falling knives'.

Now imagine a high quality residential property close to where you live. You know it well, it is spacious, in a nice and pleasant area to live and is in high demand. One day this property is on sale for 80% off its previous price. This is an example of a 'fallen angel'.

Financial markets today are full of both falling knives and fallen angels, with prices of everything coming down, offering investors a wide array of opportunities to 'buy the dip' across multiple asset classes and individual stocks.

Some of these are very risky 'falling knives', where the lower price on offer does not necessarily mean investors should go anywhere near. Bitcoin and crypto currencies are a good example of this. Bitcoin is down 71% from its highs in 2021, Ethereum, another popular crypto asset, is down 75%. Many speculators argue this makes them better investment opportunities now. We would argue these are falling knives and trying to catch them would be a grave mistake. Any price above zero for cryptos in our view is too high.

Many stocks also exhibit similar characteristics, still trading on very high valuations despite major declines in share price. Tesla stock is down 45% from its highs last year. Compared with cryptos, at least investors own something in the real world with Tesla stock, in this case an electric car manufacturing business, but again, speculators are tempted to start buying Tesla stock at these now lower prices. Again we caution against catching a falling knife here, as valuation levels still remain eye wateringly high relative to other auto companies and other more reasonably priced assets in the stock market.

Sadly, many retail investors in particular are falling into the trap of putting new money to work in these and other similarly risky assets, buying the dip and adding capital to speculate on prices of over-priced assets.

Price declines alone do not great investments make.

What matters is price relative to underlying value and the cash flows the asset you are buying will generate.

Some asset prices are down and rightly so, they were just too damned high and should be avoided even at much lower prices.

Finding the fallen angels, or at least investing in strategies where this is a stated aim, is where investors should now, we believe, be focusing their energy.

Some of the leading businesses in the world today, in previous market downturns, traded down 50% or more, seeing prices decline along with the rest of the market index at the time. Amazon was down 85% from its peak in the 2001-2002 sell-off. These price declines of our 'fallen angels' were accompanied by major declines in the price of the 'hype stocks' of the day, which never recovered.

These 'fallen angels', when bought at or close to market lows, turned out to be the best investments of the subsequent two decades. Amazon bought in March of 2001 would today have generated a 200 times return (in other words a $10,000 investment would be worth $2 million after 20 years).

The current market turmoil will be creating similar opportunities for the long-term minded investor.