Why do stocks become undervalued?

* Negative news or events: Negative news or events, such as a decline in earnings or a scandal involving company management, can cause investors to lose confidence in a company, leading to a decrease in demand for its stock and a drop in its price. If the decline in price is not reflective of the company's underlying fundamentals, the stock may become undervalued.
* Cyclical or sector trends: Certain sectors or industries may fall out of favour with investors due to cyclical trends or changing market conditions. This can lead to a decline in demand for the stocks in these sectors, causing them to become undervalued.
* Market correction: A market correction, which is a rapid and widespread decline in the stock market, can cause even fundamentally sound companies to experience a drop in their stock price. If the decline is not reflective of the company's underlying fundamentals, the stock may become undervalued.
* Fear and panic: Fear and panic can cause investors to sell their stocks en masse, leading to a decline in demand and a drop in prices. This can create buying opportunities for value investors who believe that the market overreacted to the news or events.
* Mispricing: Stocks may become mispriced due to investor irrationality or errors in valuation models. This can lead to a disconnect between the stock's price and its underlying fundamentals, making it undervalued.

Why do stocks become overvalued?

* Speculation: Investors may speculate on a stock's future growth potential, leading to increased demand and a rise in the stock price. This can create a bubble in the stock market, where the stock's price becomes disconnected from its underlying fundamentals.
* Market hype: Positive news or rumours about a company can generate hype in the market and drive up the stock price. This hype can be fuelled by social media, news outlets, or even analysts who issue optimistic reports.
* Investor sentiment: Investor sentiment can drive a share price higher or lower, regardless of the company's underlying fundamentals. If investors are optimistic about a company's future prospects, they may bid up the stock price, leading to an overvalued stock.
* Irrational exuberance: The stock market can be subject to irrational exuberance, where investors become overly optimistic about a stock's future prospects and drive up the price. This can lead to an overvalued stock that is disconnected from its underlying fundamentals.
* Low interest rates: Low interest rates can make stocks more attractive to investors who are seeking higher returns. This increased demand for stocks can drive up the stock price, leading to an overvalued stock.

**Undervalued vs overvalued stocks**

| **Undervalued stocks** | **Overvalued stocks** |
| --- | --- |
| Have a lower market price than their intrinsic value | Have a higher market price than their intrinsic value |
| Offer a potential buying opportunity for investors who believe that the market has undervalued the stock | Offer a potential selling opportunity for investors who believe that the market has overvalued the stock |
| Are usually associated with companies that have strong fundamentals, but are experiencing temporary setbacks or negative sentiment in the market | Are usually associated with companies that have weak fundamentals, but are experiencing positive sentiment or hype in the market |
| May be a good long-term investment opportunity if the company's fundamentals are strong and the market conditions are expected to improve | May be a risky investment opportunity, as the stock price may not be sustainable and may eventually decline |
| Are generally considered to be part of a value investment strategy | Are generally considered to be part of a [growth investing](https://hellostake.com/au/blog/stake-academy/growth-investing) strategy |
| May require patience and a long-term investment horizon to realise potential gains | May require a more active investment approach, such as timing the market or actively managing the portfolio |

Here is a comparison between undervalued and overvalued stocks: