3 Things To Do When a Stock You Own Crashes

A stock crash or a stock market crash is something no investor likes to experience. But if you are into equities long enough, you will experience that not once but many times.

A stock market crash does not only make an investor lose money but it also erodes the confidence a bull market instills. I believe every stock market crash an investor goes through, it makes the investor a stronger person.

> *"There's no shame in losing money on a stock. Everybody does it. What is shameful is to hold on to a stock, or, worse, to buy more of it, when the fundamentals are deteriorating."* ***– Peter Lynch***

Importance of Asset Allocation

A surge and a crash in stock prices is part and parcel of a trading day. It is these price movements that are responsible for the superlative returns that equities are known for.

This is the reason why you should NEVER invest more than 5% of your entire savings in a single stock or not more than 25% of your entire equity exposure in a single scrip.

> *Always remember that no stock in this world is safe enough that you would invest 50-60% of your money in it.*

The best stocks can crash. I have given a few examples below. I cannot stress how important it is to balance your investments and make sure your asset allocation is as per your risk profile.

However, for argument's sake, let's assume you did invest in a stock that is now unidirectional, and that too, downwards. There have been lots of recent cases that highlight such a situation.

While a stock-crash in the midst of an entire stock market crash is a different issue, here I will address the stocks that did crash even when the broader indices are doing well.

Case of Dewan Housing Finance

DHFL, once a favorite of every investor, went down from 650 levels to 50 in less than 9 months. What it took the stock for more than 5 years to gain, got wiped out in less than 9 months.

Keep in mind, this did not happen to all housing finance companies but definitely happened to DHFL. Negative market sentiments, scams, liquidity issues, etc. all coupled together to bring the price down.

Image Source: Google Finance

Canfin Homes, on the other hand, increased around 30% in the similar time as DHFL fell 90%.

Image Source: Google Finance

Case of Yes Bank

Yes Bank has a similar story and similar timeline as DHFL. While the reasons are absolutely different, thankfully it did not have scams.

The liquidity issues, change in top order management, NPAs, etc. all coupled together hurt the investor sentiment. It led the stock to fall from highs of 400s to sub 90 levels. The retail investor participation during this time doubled/tripled in some cases.

Image Source: Google Finance

Case of Gitanjali Gems

The stock of Gitanjali Gems Limited had ended at Rs 62.85 on the BSE on February 12. The news story of a massive scam at the Punjab National Bank (PNB) perpetrated by jewelers Nirav Modi and his uncle Mehul Choksi broke on February 14. The latter owns the Gitanjali group of companies.

Image Source: BSE India

Since that date, the share price of the company has continuously declined and stood at Rs 5.5 on the BSE at the end of the day on April 12th. That’s a decline of 90% in a little over two months of trading days.

What can an Investor Do in Such a Case?

While considering one's options, investors need to take into consideration the cause of the sharp decline, their level of activity in the stock market, and the time horizon of investment.

1. Why is the stock falling?

If the sharp decline in a particular scrip is in response to a general decline in the sector, but that scrip itself is not the main cause of the decline, then investors need not panic. Such downward movement should be expected in difficult times, and investors should ride the fallout. For instance, the banking sector, in general, saw a sharp decline due to a scam.

From the end of the day on February 12 until March 9, the S&P BSE Bankex fell 6%. Stocks of banking companies that have a comparatively small or no exposure to Gitanjali Gems in terms of loans extended would have also seen their stocks fall. But investors in such banking scrips should wait for a bounce-back instead of forcing a sale.

On the other hand, if the company in question is the chief cause of the decline in the sector or the stock market, and bounce back seems distant, then investors should liquidate their holding regardless of the loss. Especially if the time horizon of their investment is short-term.

Image Source: Google Finance

For example, in this case, while you should not sell all banking stocks but PNB would have been a definite sell. In the above example, you can see that the stock never really bounced back even after the news of Gitanjali Gems subsided.

2. The Time Horizon of Investment

If you are unable to decide based on the above factor then the next one would be how long can you hold the stock.

Those investors who come to know about a plummeting stock late, but have a medium to long-term horizon, can probably continue holding the stock (if fundamentals still make sense).

If a stock is clouded with scams and senior-level leadership is leaving then it's best to sell the stock even if you are at a 90% loss. Wait for a bounce-back and sell it at the first sign of a bounce back.

3. Exposure to the Stock

If the first two factors have not helped you decide the best course of action then this might.

If the stock is a small % of your portfolio (less than 1%) then you might as well continue to hold it. Make sure the stock is still strong, you can hold for the long term. However. if you have heavy exposure to the stock then it would be advisable you start selling a % of your holding with every bounce back.

Maybe sell 20-30% of your holding of that stock every time there is a bounce-back, that way you can hedge your way in selling the entire stock.

Summary

Calls on holding a stock should be taken after assessing the combination of these factors – Time Horizon, Depth of News, Current Price and Purchase Price.

While taking an exact and correct call is not possible every time, evaluating the type of news will give a signal about the direction of sentiment for the stock.

Adverse financial statements news will be absorbed in the prices for a few days and the incremental correction happens in a few days or weeks' time. However, news like credit issues, insolvency, fraud are "black swan" events and only indicate the downfall of the stock. Thus, a quick exit is always advised to retail investors when in doubt.

Cover Image Source: Spectator.co.uk