Why A Falling Stock Is Not Always A Bargain
by Derek Simon (Contact Author | Biography)

An old axiom warns investors not to "catch a falling safe", a reference to the fact that a falling stock is not always a bargain. For every solid company whose stock is experiencing a temporary downturn, another is punished by the market for very good reasons and may not recover. To "buy low and sell high" successfully, it makes sense to find undervalued stocks that are trading for less than they should. The trick for investors is separating a temporary stock pullback from a prolonged – and perhaps irreversible – downturn.

Pullback Vs. Regression

One analytical tool that can help investors identify a pullback is an examination of a stock's pricing trends. It is important to distinguish between a (positive) price pullback, defined as a brief reversal of a prevailing upward tendency, and a (negative) price regression, or overall downward trend. While making the distinction appears to be about as simple as distinguishing mud from water mixed with dirt, the process is actually fairly straightforward.

Take, for example, J.C. Penney (NYSE:JCP) during the winter of 2007. From October 5 of that year, when Penney's closed at $68.71 – its highest level in nearly two months – until November 21, when JCP finished the day's trading session at $40.07 (32 days short of a three-year low), the stock steadily declined. Fundamentally, however, little had changed about the company. And, what happened next? Less than three weeks later, Penney's stock was trading in the mid-40s again. (For more on how this works, read *Battered Stocks That Bounce Back*.)

Lehman Brothers Holdings (OTC:LEHMQ) presents an entirely different set of circumstances. Once traded on the New York Stock Exchange under the ticker symbol LEH, Lehman Brothers was delisted by that exchange on September 17, 2008 after the firm filed for bankruptcy and was removed from the S&P 500 Index. Unlike J.C. Penney, Lehman's fundamentals *had* changed. Even before the bankruptcy, it was clear that the 158-year-old lending giant had become too entangled in the subprime mortgage mess than was fiscally prudent and was suffering serious financial repercussions. (Take a look at the factors that caused this market to flare up and burn out by reading *The Fuel That Fed The Subprime Meltdown*.)

Lehman's subsequent share price free-fall was not a pullback but, rather, a realistic assessment of value – leaving safe catchers vulnerable to getting clobbered.

Technical Analysis

Beyond poking into a company's fundamentals, there are a few other ways of identifying pullbacks and regressions. By attempting to determine what technical traders refer to as support and resistance levels, prudent investors can often find critical entry and exit points for the stocks they're trading. (For background reading, see *Support & Resistance Basics*.)

In general, a resistance level is a price point at which sellers are believed to overwhelm buyers, preventing a stock from advancing any further. A support level is just the opposite, a price point at which buyers are thought to overwhelm sellers, thus providing a barrier against further decline. Most often, these levels are established by examining a stock's behavior in relation to its Bollinger bands or by using the Fibonacci sequence and associated "golden ratio".

Bollinger Bands

Bollinger bands, named for their creator John Bollinger, are a series of three-line graphs. One line represents the stock's 20-day moving average and the other two are the standard deviations above and below it. According to Chebyshev's mathematical theorem, 75% of all future price movements will be confined between the upper and lower bands, so traders often use them to define pricing support (lower band) and resistance (upper band). (*The Basics Of Bollinger Bands* goes into Bollinger band analysis in greater detail.)

Fibonacci Sequence and the Golden Ratio

Many investors use the Fibonacci sequence and golden ratio in the same manner.

Based on the work of Italian mathematician Leonardo Fibonacci, the Fibonacci sequence consists of an unending series of numbers - each the sum of the prior two terms (1, 1, 2, 3, 5, 8, 13, 21, etc.). Dividing the last number in this sequence by the preceding figure provides the golden ratio, or Phi, which is equal to approximately 1.618.

Thus, support/resistance levels are derived by dividing/multiplying the stock's moving average over a given time frame by 1.618. Sometimes, intermediate ratios, such as 1.500 and 1.382, are used as well.

Figure 1 is a demonstration of Bollinger bands and the golden ratio in action, using the aforementioned examples of Lehman Brothers Holdings and J.C. Penney.

Measures	**J.C. Penney**	**Lehman Brothers Holdings**
Close	$40.07 (Nov. 20, 2007)	$7.79 (Sept. 9, 2008)
20-Day Moving Average	$49.58	$14.74
Bollinger Range	$38.48 - $66.24	$10.76 - $20.70
Golden Ratio Range	$30.64 - $80.23	$9.11 - $23.84

Figure 1

Notice that although Penney's November 20 close was the company's lowest in more than two years, it did not break either the Bollinger or golden ratio support levels. In fact, when the stock briefly dropped below $40 earlier in the day - important to the many who believe that round numbers form psychological support and resistance levels - it promptly rebounded. Such was not the case for Lehman Brothers on September 9, when the stock plummeted past all pre-existing support points to finish the day at $7.79.

Five trading days later, J.C. Penney closed at $44.53, while Lehman Brothers stood at 30 cents per share. (For further detail on Fibonacci analysis, check out *Fibonacci And The Golden Ratio*.)

Other Methods
Investors may also wish to consider volume in their quest for undervalued stocks, something that can be easily accomplished by using a volume-weighted moving average as a starting point.

Bollinger bands and the golden ratio are not the only ways to determine support and resistance levels. Often, observation or intuitive measures work just as well. It's also important to remember that many investors who use analytical tools such as these also base decisions on other factors, including a company's financial characteristics, growth prospects, stock valuation, industry and economic outlook, and other company-specific features or economic trends that may influence stock price.

Conclusion
Whatever method one ultimately chooses, it's important to remember that the practice of trading pullbacks is inherently risky, so it is probably wise to institute stops and limits when employing such a strategy.

And be sure to watch for falling safes.

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