Avoid the disaster, and prosper

By James Middleweek, Investment Analyst and Director at Valueinvest

First, let me say that I tend to invest (and trade) in small and mid cap stocks. Gains in these stocks can often far exceed those of their larger brethren. The flipside is that there is typically a much heavier price to pay if things don't go to plan. Plenty of stocks drop more than 35%, sometimes 50%, on a bad announcement. Losses like this are hugely damaging to any portfolio.

There are a number of ways to mitigate this risk. one of my favourites is to closely follow changes in earnings forecasts. When the broker's numbers start to dip downwards, it's often an early warning sign of bigger trouble ahead. Often brokers won't issue a recommendation change (especially if they want the corporate work), but they will trim earnings forecasts.

My strategy is to try to buy out of favour stocks, where earnings forecasts are at least stabilising, or, better still, starting to get upgraded. An earnings upgrade after a prolonged period in the doldrums is often a sign of significant outperformance - it takes time for investors to wake up to the change. Remember also that earnings upgrades can happen two or three times once a stock gets on a roll.

A classic example of this is Service Stream (ASX:SSM). In February 2015 Service Stream announced a return to profitability and a modest dividend. This largely went unnoticed by the market. But the more significant event was the earnings upgrade which followed in May 2015. Over the following year Service Steam's share price rose from 25c to 80c, as more investors jumped on board and further upgrades followed.

You can easily find changes to earnings trends on trading platforms such as Commsec. They are a much underrated tool for the private investor.

Another way I find to minimize trading risk is to purchase a share not long after a results announcement, AGM statement or trading update. That normally gives me a period of time, perhaps 6-8 weeks, when I can be reasonably confident that there won't be a surprise announcement. If the shares perform well during this period, I will more than likely continue to hold. However, I am very wary of losing positions – they can be a portent of things to come.

My own stop loss rule is somewhere between 10-15%. I take the view that I can always enter the stock at a later date. I simply will not follow a stock down 30%, 50% or even 100%, in the vain hope of getting my money back. Better take the hit, move on, and perhaps revisit at a later date.

Remember, the one major advantage that the private investor holds over a large fund is that you can be nimble. There is normally enough liquidity for you to exit a stock without too much difficulty, and at negligible cost. Use this to your advantage to sit out periods of underperformance. You can easily return to the stock once it has "stopped raining".

Of course, no strategy is ever perfect. If you are the victim of a shock warning, what do you do? The main thing you should ask yourself is: am I reasonably satisfied that a poor announcement doesn't change the fundamental qualities of the business, the markets in which it operates, or its trading prospects beyond the short term (which I define as no more than 9 months)? If the answer to the first two questions is no, you may want to revisit your investment thesis for the stock. But cloudy trading prospects are also worrying in that they provide opportunity for further earnings downgrades.

When it comes to taking a loss following a profit warning, it often pays to follow the old Cat Stevens adage "the first cut is the cheapest."

Having said that, a profit warning can sometimes offer a great trading opportunity. Look at the example of Programmed Maintenance Services (ASX:PRG). In the three months prior to a trading update in February 2016, the stock fell from $3 to $2. This was an early warning sign of the trading update that followed, which blamed a lower oil price and higher integration costs from the Skilled acquisition. The stock then got smashed to a low of 93c. But Programmed was never a bad business, and the fundamentals had not changed. Quite the reverse, the Skilled deal would only strengthen its market position and leverage to recovery in its markets. In the space of a few months the stock has doubled to $1.80.

Being left "holding the baby" is never a nice feeling. Hopefully this article will assist you in minimising those risks, and making a well informed decision if disaster should strike. E