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Keeping your head when all about you are losing theirs

Tom Jacobs

Every investor at some point faces a stock crash. No matter how much you research the business and scrutinize the risks, you will rise one day to find that a stock has plunged 25%, 50% or even more. Panic and inertia ensue. What to do?

There is no one-size-fits-all answer, because unless a cataclysmic event—9/11, for example—hammers the market broadly, a stock explodes for company-specific reasons. For the vast majority of biotech stocks that are drugmakers with product candidates as opposed to currently marketed products, these dives come with bad news at major milestones facing their lead drugs. Perhaps poor or neutral trial results lead a company to pull a drug from development, a regulatory agency slows down or disapproves a drug application or a competitor hits the market first with a better product.

Here are tips on what to do when your stock plummets dramatically. The first is preparation for the event itself and the rest cover what to do after.

Don't panic!

First, be prepared for stocks to go down. Even the very best investors have this happen to them, whether from major company-specific news or broad-market emotion, so the ability to handle a 50% fall, say, is the admission requirement for buying individual stocks. Accept that you will almost never buy a stock at its absolute bottom (or sell at its top), so at some point a stock you buy will sell for less than what you paid—perhaps a lot less.

Have an investment thesis

The second preparation is to never, ever invest without a thesis: write down why you bought the stock, what you might do in different outcomes and why. Then, if a stock collapses, you can determine whether whatever led to the stock fall is relevant to you and whether you should sell. You can be calm, collected and rational while others are weeping, wailing and gnashing their teeth.

Let's say you decide to buy a newer biotech drugmaker with one lead product. Ask yourself what you would do if the drug were disapproved: would you sell? If drug approval were delayed, do you know whether the company would have enough cash to finance further development? Even if the drug were approved in the time frame you expect—hallelujah!—have you prepared by estimating the potential market size, how long it will take to ramp up sales to that market, and what competition might be on the horizon? And if everything should come up roses, do you know what revenue share arrangement the company has with its large pharma partner?

Too often, investors react emotionally, buy a stock and sail without a rudder. You can always adjust your course later, but you must have one in the first place. No one gets an advanced degree without a thesis, and no investor other than a rank beginner should bet money without one either.

Forget the price paid

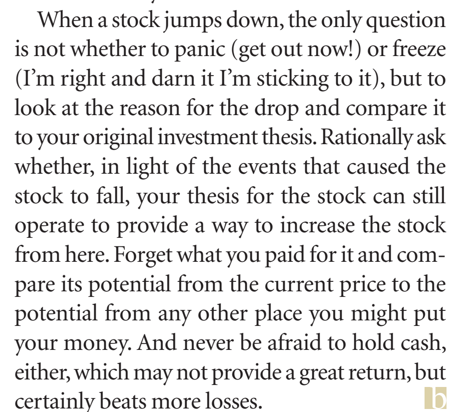
The single most common question I'm asked when I speak to investors is whether such-and-such a stock will "come back." They own a stock that's slumped considerably, but rather than ask what I think a stock's merits as an investment are right now at its current price, they are focused on getting back to even (that is, what they paid). Behavioral economists call this an example of mental accounting, and it's just plain wrong.

That's right. All else equal, if a stock descends from $20 to $12, it doesn't matter whether you paid $30 or $5. All that matters is whether given the reasons you invested, the developments in the business, and whatever news may have caused the stock to drop, you think that the stock is a better or worse place for your money today given all the alternatives. So ask yourself this after a large decline: If you had absolutely no history of buying this stock—no emotional baggage at all—what would you do now? And if you were canny enough to write out a plan of action for different outcomes as part of your original investment thesis, the answer will be easier.

Sense versus emotion

Most individual investors do poorly because they typically buy at times of stock market or company enthusiasm and sell at a nadir. This is because they let emotion, rather than reason, govern their behavior.

The stock market in the short term is bipolar: it swoons over good news and mopes around after bad. Whether bulls or bears, traders stampede this way and that in classic herd fashion. So if a stock plunges 50%, hard as it may be, we should relax: we can't do anything about the past. What's more, chances are that the market's emotion will work itself out quickly—in a day or two—and for all you know, the stock might rebound somewhat. Even dead cats bounce. If it goes down some more, your additional loss is almost always not that much more. Make your decision calmly.



When a stock jumps down, the only question is not whether to panic (get out now!) or freeze (I'm right and darn it I'm sticking to it), but to look at the reason for the drop and compare it to your original investment thesis. Rationally ask whether, in light of the events that caused the stock to fall, your thesis for the stock can still operate to provide a way to increase the stock from here. Forget what you paid for it and compare its potential from the current price to the potential from any other place you might put your money. And never be afraid to hold cash, either, which may not provide a great return, but certainly beats more losses. ◼

Tom Jacobs is cofounder of Complete Growth Investor (http://www.completegrowth.com). He welcomes your comments at tom@completegrowth.com.