The Perils of Buying Low

Let’s say you’ve got an extra $4,000 laying around, and you’d like to invest it in the stock market. Which of these options sounds more appealing to you? Would you rather buy: (a) 1,000 shares of a stock currently trading at $4 per share, or (b) 80 shares of a stock selling for $50?

In scenario (a), a $1 increase in the price of the stock represents a 25% gain. You would have an extra $1,000 in your pocket if that were to transpire. Whereas a $1 price gain for the stock in scenario (b) is a paltry 2%, equivalent to just $80. And as any schoolchild can tell you, $1,000 is a much bigger number than $80, so of course you should prefer option (a), right?

Right?

To be perfectly blunt about it, no. That logic is completely wrong. In fact, that sort of thinking could be dangerous to your financial well-being. So if the stock in scenario (a) was in fact more appealing to you, please read on to find out why you need to change your thought process.

On the other hand, if the question in the first paragraph seems silly to you, and you concluded that—not possessing any other information about these two hypothetical investments—(a) and (b) are essentially equivalent, then good for you. You have earned an A in today’s class on finance. You can stop reading this article, go outside, and play.

Let’s Experiment

To help us see why our original question is nonsensical, let’s engage in a few different thought experiments.

First, let’s ask ourselves how big the companies in question are. That is, sure Stock A is $4 per share, but how big is Company A? Since this is our article, we can make up any number we want, so let’s say there are 1.25 billion shares of Company A available to purchase on the open market. That means that the total market capitalization of the company, or the theoretical price required to buy the whole thing outright, is $5 billion. Perhaps Company B only has 62.5 million shares outstanding, though. If that’s the case, then B’s market cap is also exactly $5 billion (i.e., 62.5 million shares x $80 per share).

So which company is more likely to grow its value by 25%: Company A, worth $5 billion, or Company B, also worth $5 billion? Do you see? Without knowing the total number of tradable shares a company has, the share price tells you nothing about how large the enterprise is and, therefore, nothing about how likely that enterprise is to grow.

Now, let’s add another dimension to this thought exercise. Let’s say Company A and Company B are each worth exactly the same amount, but now let’s specify something about what sort of businesses they are, and let's also say that the year is 1925. Company A's predominant business is the manufacture and sale of buggy whips for horse-drawn carriages, and Company B's predominant business is owning and operating radio stations. Knowing all this, which would you rather own during the Roaring Twenties—1,000 shares of the buggy whip maker, or 80 shares of the radio company?

Same Same

For another angle on the issue, we can look at Amazon's stock, which is trading for about $1,500 per share at the time of this writing. With approximately 500 million shares of stock in the world (including the dilutive effect of shares owned by employees via the company's equity compensation plan), that means that the total value of Amazon is around $750 billion. This makes it the fourth-largest publicly-traded company in the world, by market cap.

Some investors bristle at the thought of paying $1,500 for just one share of stock. The high level of that absolute number, as compared to most stocks which trade for less than $100 each, scares some away.

But what if Amazon were to declare a 200-for-1 stock split tomorrow? That is, for every share of Amazon an investor owns today, tomorrow when she wakes up she will then own 200 shares of Amazon. In such cases, the market price of the stock immediately and automatically adjusts to reflect the new reality. Which means that, starting tomorrow, you could buy a share of Amazon for just $7.50, which sounds like a great bargain compared to its current price. If you're the sort of investor who would not buy Amazon due to its high price for a single share, would a $7.50 price tag make you more apt to buy the stock?

We hope not, but if you're still having doubts about it then consider it this way. Today Amazon has 500 million shares which trade for $1,500 each, meaning that the overall value of the company is $1,500 x 500 million, or $750 billion. But in our hypothetical situation, tomorrow Amazon would have 100 billion shares (i.e., the original 500 million shares multiplied by the 200:1 factor from our imagined stock split) trading at $7.50 each. And, of course, $7.50 x 100 billion is exactly equal to that same $750 billion market cap.

Amazon is no more likely to grow its value at a faster clip when its stock is selling at $1,500 than it would be if it were selling for an equivalently-valued $7.50. Its business is going to keep humming along at its natural clip, and the number of its shares outstanding is completely irrelevant to the revenues and profits it generates.

This line of thought calls to mind that famous Yogi Berra quote. When asked how many slices he wanted his pizza pie cut into, Yogi replied, "You'd better cut the pizza in four pieces, because I'm not hungry enough to eat six."

Final Word of Warning

As if all of that was not enough to disabuse you of the notion that you should primarily be fishing in the pond of low-priced stocks, let us give you one other point of caution. Many low-priced stocks, especially those that also have few shares outstanding and therefore a very low market cap, can be manipulated by scammers at your expense. The typical mechanism used for such manipulation is known as “pump and dump,” which is an illegal scheme that enriches its perpetrators at the expense of its victims.

A “pump and dump” operator first buys a significant holding in a thinly-traded low-priced stock. Once that position is established, the “pump” phase starts. In this, the scammer uses any means available to hype, or “pump,” up investor excitement about the stock in question. Email distribution lists, articles on financial blogs such as Seeking Alpha, anonymous phone calls offering “hot tips,” and posts on social media are all tools used by the scammer to generate interest among other investors to buy the stock, usually promising a quick windfall for those who will buy it.

Through the elementary laws of economics, any time the demand for something increases while its supply remains constant, its price will re-set quickly to a higher level. These “pump and dump” stocks do not suddenly issue more shares, so their supply remains constant. So if the scammer can generate enough demand for the stock, through a large enough group of suckers willing to buy it, then its price should rise significantly. It is at that point that the “dump” phase of the scam begins, in which the perpetrator sells all of their shares. That is, they “dump” them back on the market. Orchestrated properly, a pump-and-dump scheme can generate a quick and tidy profit for the criminals running it, while simultaneously causing a permanent loss of capital for its victims.

That’s not to say that all stocks with single-digit prices are scams. Far from it. Over the last decade, many reputable companies have had their stocks trade at extremely low prices at one time or another. Citigroup, Xerox, eBay, and Weight Watchers, to name just a few, have all traded at single-digit prices in the not too distant past.

The bottom line is you should not gravitate to buying low-priced stocks simply because their prices are low. At the same time, don’t shy away from a potential stock investment just because it sports a low price. Just do your homework, and look before you leap.

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