The Alchemist
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Picking the bottom of a share price fall is meant to be a mug's game. 'Bottom pickers' become 'cotton pickers', goes the saw.

The easiest way to find a share that has hit its bottom is to search for a company that fell some time ago, and is now simply languishing, semi-forgotten.

A quick check of the news record and the balance sheet will tell whether it is a solid company, worthy of further consideration. Most falling stocks do not snap back. They fall and fall until no one cares to remember that they held the shares in the first place, or couldn't care less to buy back in.

Normally an event such as a takeover or a change in management will snap the stock out of its torpor, but this can take a long time.

For stumbling shares, like AstraZeneca, the bottom can be very far away indeed, and a quick look at the chart gives no obvious reassurance for the proto-cotton pickers.

However, there are more ways to invest than simply buying a share in the hope that it is going to stop falling and instead rise up. My favorite example is Orange.

Orange was a cheap stock in comparison to Vodafone. Although roughly equivalent businesses, Vodafone, however, had a comparatively higher valuation for the amount of business it was doing.

The simple solution would have been to buy Orange and wait. This would have turned out a perfect call but, at the time, the whole Telco and Technology sector was melting down.

Trying to pick two bottoms in the market and in Orange was, indeed, one speculation too many. So did that nix a bet on Orange?

The answer is 'no'.

This is how a little sophistication can yield big returns. The answer lies in pairs trading - go long on Orange and short on Vodafone. If the Telco sector continued to fall, the short on Vodafone would cover the loss in Orange from a profit on the short position. Likewise, a rise in all Telco stocks would be balanced by a profit in the Orange position, cancelled by a loss in the Vodafone short. Only the closing of the extreme valuation gap between Orange and Vodafone would create a profit. Eventually, French Telecom would reabsorb Orange at a nice premium.

This is a classic 'hedge' trade, and these days anyone with a CFD or a spread betting account can be his own hedge fund.

Though banks are having a bonanza, Lloyds TSB continues to languish at the bottom of the pack, just like Orange. While trailing its peers, Lloyds pays out a handsome dividend of 7% on a P/E of 8%. Meanwhile, Barclays and HSBC, on 14 and 17 P/E respectively, pay out 3.5% and 2.4% dividends.

Grossly, Lloyds is valued at half price compared to its peers. These situations can go on for a long time and Lloyds share price performance diverged from the other banks almost three years ago, and has been flat for nearly two. The whole banking sector looks good, but banks are uncomfortably close to the "political football" zone.

In the new nanny state reality, they could get chastised for making too much money. This is where pairs trading can protect the investor. If banks get punished for lending us poor fools more money than is good for us, the short part of the pair will protect us from the bad news, while a normalisation of pricing between banks like Barclays and the trailing Lloyd's, will deliver the profit. Good old boring investors, like myself, will be tempted just to by a bunch of Lloyds shares and stash them for the long term, but where's the fun in that?

Clem Chambers is CEO of ADVFN, Europe's leading stocks and shares website. For free real-time share prices go to www.advfn.com .