Brent Sheather's

RESEARCH

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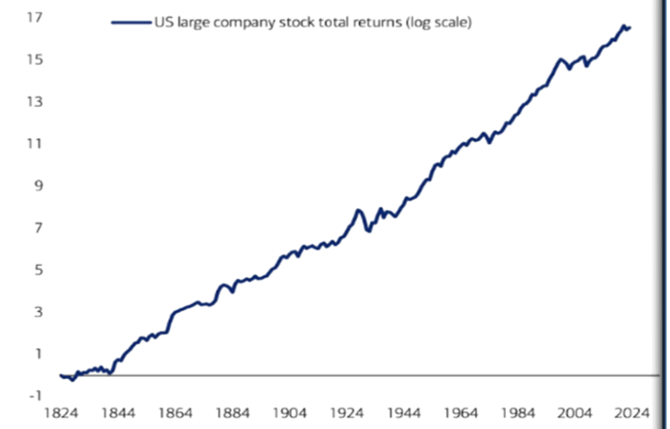
BUYING THE DIP – PART 1

An Internet search of "buying the dip" defines that strategy as "*Purchasing an asset after its price has temporarily fallen, expecting it to rebound and increase in value. It is based on the principle of "buy low, sell high". Investors believe the price drop is a temporary setback and that the asset will eventually recover*". With the US stock market retracing virtually all of its February-April tariff tantrum inspired losses by mid-May the time is right for a deep dive into "buy the dip". Readers should note however that the following discussion relates to buying the broader market not individual stocks as falls in the latter can be due to factors specific to single companies or industries.

Buying the dip (btd) has been an outstanding success for many years now, so much so that it's pretty much ingrained into investors psyches. That is not altogether surprising because the stockmarket goes up more than it goes down. If you look at the graph below of the US stockmarket

Chart 27: In the long run, stock prices go up
US large company stock total returns, log scale



Source: BofA Global Investment Strategy, Ibbotson, Global Financial Data

since 1824 every dip is quickly offset by the inexorable upwards trend. What a very long term logarithmic graph like this doesn't show us however is that some of the "dips" lasted for a long time and when markets fall and keep falling investors can get quite depressed. It's easy to lose confidence in shares if you btd and then lose money for five years or more.

The Global Investments Returns Yearbook has useful information on the duration of dips, which the authors describe as "drawdowns". They define a drawdown "*as the difference between the portfolio's value on a particular date and its high-water mark. The interval from the date of the high-water mark to breaching the high-water mark again is the recovery period. The investment is underwater from the date of the high-water mark to the end of the recovery period*". In NZ the biggest drawdown, in nominal terms, occurred in the period October 1987 to December 1990 when stocks fell by 59%. The sharemarket then slowly recovered but it took until October 1995, a period of eight years, for an investor who bought the day before the crash to get their money back. If you bought the dip the day after the initial crash on 20/10/1987 even five years later you would still be down by 42%. I vividly remember the day after the crash, the phone going berserk with retail investors buying those stocks that had fallen the most. The market rose that day but the day after it sold off again provoking more dip buying followed by more falls. Gradually the phones went quiet as it started to sink in that btd wasn't a particularly useful strategy when markets keep on falling. The GIRY looks at drawdown and recovery periods in real terms, ie combining the impact of the drawdown and inflation: the authors calculate that an investor who bought NZ shares a day before the crash would have had to wait 16 years to get their money back in real terms. That is a very long time due to the extent of the downturn combined with high inflation.

After the Wall Street crash in October 1929 US shares fell to a low in July 1932 that was 79% below the September 29 peak, adjusted for inflation, according to the GIRY. "*The steep drawdown and long recovery period – in total fifteen and a half years – set contemporary stockmarket fluctuations in a historical context*". According to the GIRY during the Global Financial Crisis the real return for the world stockmarket from its peak in October 2007 to its low point in March 2009 was negative 58% and it took until February 2013 for investors to get their money back.

Another way of approaching this topic is to consider why sharemarkets sustain big downward trajectories every so often: the share price of a company is based on two major variables: future profits discounted at an appropriate risk adjusted interest rate. Share prices fall when investors perceive that either or both of these variables will change for the worse. Lower profits and/or higher discount rates mean shares should trade at lower levels. Higher levels of inflation would mean that interest rates, and thus discount rates, would increase. The worst case scenario is a deflationary shock where economic activity plummets and interest rates fall, with the first factor overwhelming the latter. We also need to acknowledge that the market isn't 100% efficient in translating changes in these variables into prices due to the obvious problems with forecasting things in the future and, during downturns, leveraged and nervous players exiting in a hurry.

It seems to me that a "btd" reflexive response must be based on one or more of five assumptions, only the last four of which are rational:

1. That the bad thing has impacted share prices but will not affect profits or discount rates ie shares are genuinely cheaper than they were. Stockbroker marketing often refers to "shares going on sale", a pitch which is good for "funds under management" but an affront to the notion of efficient markets.
2. The bad thing will get resolved satisfactorily soon – more quickly than the market thinks.
3. The bad thing that has happened isn't as bad as the market thinks.
4. The response from government will quickly make the bad thing go away.
5. The bad thing is bad but the market has overreacted due to panic and leveraged players exiting without regard to price.

Let's consider these explanations using the tariffs announced on Liberation Day as our example of a "bad thing": the market initially fell on the tariff news because tariffs were going to reduce economic growth and thus profits and there was a perception that uncertainty and thus risk had increased. So, from a discounted cash flow perspective, that hurt both the numerator and the denominator in the NPV equation – cash flows were lower and the discount rate was higher. So share prices fell to reflect the lower value of the discounted cash flows. Buyers at that time would have based their buy decision on one or more of those five rationales. With hindsight, and given subsequent events, it seems that explanations 2 and 4 best explain buyers' thought processes.

Institutional investors are notoriously critical of retail players, frequently arguing that taking advantage of their naivety allows them to outperform. If one believes that narrative and acknowledging that retail is quick to btd then perhaps the most frequent rationale for retail dip buying is that provided by option one: ie they see share prices are down so assume "shares have come on sale". It's easy to label this approach as irrational given that markets are relatively efficient: just because you don't understand why prices are down doesn't mean that they haven't fallen for good reason. My view is that this is what happened in 1987 in New Zealand – retail investors saw that prices were lower and didn't realise that they were lower because the good times were over. Professional investors love disrespecting silly retail but the bottom line is that if you bought most dips in recent times you would have done better than if you were a "smart" institutional investor doing the selling. A recent issue of Grant's Interest Rate Observer appraised the performance of retail vs institutional investors as follows: "Who's the dumb money now? Retail investors got the better of the institutional crowd during the recent tariffs-induced stock market round trip, as the former contingent's buy-the-dip proclivities paid off in a big way. '*In the face of daunting headlines, retail investors showed the power of diamond hands while the pros flinched*,' Roundhill Investments CEO Dave Mazza told Bloomberg Thursday. '*Retail isn't constrained by benchmarks or answering to uneasy clients, so they ploughed ahead and bought the dip, which worked once again*.'"

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.