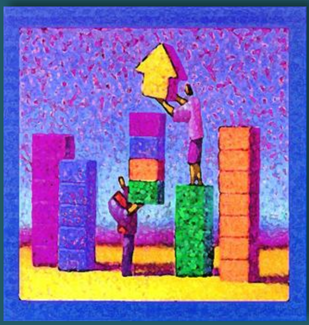

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BUYING THE DIP – PART 2

Two weeks ago we reviewed the strategy of, and rationale for, buying the dip. Today we will continue that topic speculating that the recent "dips" may not offer a good indication of future dips both in terms of duration and amplitude. We will also look at why the btd strategy has become so popular including the behavioural incentives involved.

In the 2025 Global Investment Returns Yearbook the authors note that the worst five year periods ever for the world's major stockmarkets occurred way back in the past, before the turn of the century, with the most recent record five year decline sustained by the UK stockmarket in 1970-74. In contrast, more recent drawdowns such as the Covid-19 bear market were done and dusted much more quickly. The GIRY advises "*that the world stockmarket took one month to hit its nadir of -35% and then fully recovered within five months*". It is likely therefore that today's stockmarket investors have a very different perception of risk than individuals who endured the traumatic downturns of the distant past.

Its thus worthwhile considering why the extent of drawdowns in recent times have been limited and whether or not recent experience represents a better model of the future than the dark days of 1929 (USA) and 1987 (NZ). One big factor limiting the downside of modern day "dips" has been the tendency of the central banks to underwrite equity and bond markets so as to limit their impact on the real economy. The assumption that central banks would rush to the rescue was popularly known as the "Greenspan put" back in the day. Investopedia notes that this assumption "*ushered in an era that encouraged risk taking since it was expected that the Fed would be tacitly providing insurance against excessive market decline. Greenspan most often used a reduction in interest rates to stem market declines.*" Back in 2008 in NZ we saw the Reserve Bank guarantee not only the major players in the banking system but also the finance companies. That was extraordinary and with hindsight maybe over the top. Is it reasonable to expect the same sort of energetic response from central banks in the future? They will almost certainly do something but three factors might be relevant here: obviously we can't assume anything with President Trump in charge, government debt levels are much higher today than they were back in 1987 and 2008 thereby possibly limiting the size of any response, and lastly in New Zealand we now have the Open Banking Resolution Scheme whereby if things get really bad bank depositors may be required to take a haircut to bail a bank out.

As alluded to in Part 1 the increased popularity of btd, particularly amongst new investors, is fundamentally a behavioural response and behaviour depends upon experience. Jason Zweig expanded on this point in a recent Wall Street Journal column in which he referred to and interview with the famous investor and market historian, the late Peter Bernstein. In that interview Mr Bernstein said "Markets are shaped by what I call "memory banks." Experience shapes memory; memory shapes our view of the future. There really is such a thing as a "paradigm shift," when people's view of the future can change very dramatically and very suddenly. That means that there's never a time when you can be sure that today's market is going to be a replay of a familiar past." In a recent WSJ column Mr Zweig expanded on Berstein's thinking as follows: "With the turmoil over tariffs jolting the markets day after day, the most significant question for investors is this: What's in your memory bank? If you're young, you know stocks and bitcoin can lose money at lightning speed. Just think of March 2020 or 2022. But your experience also tells you they will bounce back even faster and go on to new highs. If you're a middle-aged bond investor, you lived through almost nothing but falling interest rates and bountiful returns from 1981 through early 2022. In an earlier generation, the stock-market crash of 1929 haunted many investors, who shunned stocks for decades after. The problem is that your memory bank can deceive you in dangerous ways. Your experience of the past is a reasonable guide to the future only if the future turns out to resemble the portion of the past that you've lived through. And it often doesn't".

No discussion of btd is complete without reference to the tendency of many investors to engage in "getevenitis". Getevenitis refers to the compulsion many investors feel, if they buy a stock and see it go down in price, to buy more shares so as to reduce their average price. The cost of an investment is an extremely important number for investors - arguably more important than any valuation metric. Investors focus on it because of loss aversion – investors don't like actually crystalising a loss partly because this involves admitting they made a mistake. Therefore a strategy of buying more shares at a lower price appeals due to the fact that reducing their average cost, thereby potentially permitting them an exit at break-even more quickly, reduces the cognitive dissonance involved when they review their portfolio performance. I heard of an investor who only owned one stock, Ryman, which he bought when they were about $11 and he consistently bought more shares so as to average down his cost price. Apparently he abandoned this strategy when they were about $5.00 and today they are about $2.60. I must admit that I have been seduced by getevenitis myself and my biggest personal investment mistakes have involved this weakness. Good financial advice often involves recommending a client exit an investment at a loss but it's a risky strategy from a career perspective: clients don't want to do it so it's a huge test of their trust. Many advisors decide it's not worth the risk, particularly if the loss making position was as a result of their advice, so decide to tell the client that "it's fundamentally a good company, the market doesn't understand it and it's undervalued ".Hence the old stockbroking joke that "the definition of a long term investment is a short term investment that went wrong". I recall advising a new client to sell, at a big loss, some small NZ company which she had bought based on her own analysis. Subsequent to the sale the shares immediately rose by 50%. She was irate and moved to another stockbroker. A year later they had gone bust.

To sum up, a simplistic overview confirms that btd as a strategy is a good move but not because a contrarian approach offers much in the way of tangible value. It works simply because sharemarkets go up in the longer term. BTD also confers important psychological benefits associated with "getevenitis". But there are costs associated with this strategy. If we think about a contrarian approach more deeply what else does it imply? To be able to implement a "btd" strategy an investor either must have cash available or move funds from other asset classes, like bonds. Having a cash reserve available means that an investor had funds uninvested so there's an opportunity cost associated with btd. Critics of market timing strategies argue that more money has been lost trying to avoid the next market crash than by market crashes themselves.

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