Beyond the Jargon: Averaging down

A stock in your portfolio has fallen 30% since you bought it; is the market telling you something, or is it just better value than before? This is one of the most important questions an investor faces on a regular basis. Averaging down is when an investor buys more stock in an existing position, despite sitting on a loss. Whether or not this seems like a good idea comes down to a philosophical question – do you think you know more than the market? If so, then a falling share price offers the opportunity to pick up shares at a more attractive price; bargain! Conversely, if you think that the market is sending you a message, it might be time to cut your losses and run.

Alternative terms: Doubling down

Short explanation: Purchasing further stock when an existing position is at a loss.

More detail: If a stock is good value at a dollar, it must be twice as good value at 50c, right? Well, as it turns out, there are vastly differing opinions on this.

Warren Buffett's mentor, Benjamin Graham, famously explained the attitude of the traditional value investor with the 'Mr Market' allegory:

"...Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.

If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a $1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position." – Benjamin Graham, The Intelligent Investor, first published 1949.

On the other side of the argument, the influential 18th century economist, David Ricardo, was said to have "amassed his immense fortune by a scrupulous attention to what he called his own three golden rules, the observance of which he used to press on his private friends." The three rules were; 1) Never refuse an option when you can get it, 2) Cut short your losses, and 3) Let your profits run on. "By cutting short one's losses, Mr. Ricardo meant that when a member had made a purchase of stock, and prices were falling, he ought to resell immediately. And by letting one's profits run on he meant, that when a member possessed stock, and prices were raising, he ought not to sell until prices had reached their highest." – James Grant, The Great Metropolis, first published 1836.

So, to say that this argument is an old one would be an understatement.

Modern professionals and academics have extensively studied both side of the argument, but the disagreement remains. Nobel Prize winner and father of the efficient market hypothesis, Eugene Fama would argue that following a trend offers no protection nor outperformance. On the other

hand, billionaire hedge fund manager and founder of AQR Capital, Cliff Asness, is a strong believer in the power of following a trend – and has decades of data to back it up.

For a local perspective on the topic, I reached out to two Livewire contributors to understand how they think about this issue and their reasoning.

No rules on this nuanced topic

Steve Johnson, Chief Investment Officer at Forager Funds

"All other things equal, the logic is irrefutable. But when is everything ever equal? Blindly doubling down is very dangerous - and I have seen it wreck many a fund manager's career.

Sometimes we buy more of things that have fallen, e.g. RHG Mortgage Corporation or Macmahon Holdings. Sometimes we sell things after the share price has fallen 80%, e.g. RNY Property Trust recently. We are constantly trying to weigh up price and value, irrespective of recent movements in the share price."

Wait and see is the safest approach

Karl Siegling, Managing Director & Portfolio Manager at Cadence Capital

"The trend is your friend and fighting the market is only for the very brave. This should always be the starting point when a stock price starts falling.

*The next mistake people make is to refer to the 'fundamentals' to justify adding to a falling stock. 'Fundamentals' that accurately predict earnings per share one, two, and three years into the future are rarely available. In most businesses, these forward earnings are difficult to predict and often based on **assumptions**. A more accurate description of the situation is that you are buying a falling stock based on **your assumptions** of the forward earnings for a business. What if your assumptions are wrong? What if other market participants have more accurate assumptions of the future earnings potential for a particular business? It is best to wait and see if the stock price recovers to confirm that your assumptions could in fact be accurate. 'Wait for the safe to bounce before you try to open it!'"*

Karl Siegling explains his view on this in more detail in this wire.

Conclusion

As with many aspects of investing, there's no clear answer as to the right thing to do. Investors will need to consider their strategy, their risk tolerance, and their level of confidence before decided on the best approach for them. However, I hope you've learned a little more about the opposing points of view.

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