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Buy The Dips

Stock market volatility has returned, and opportunities for investors abound. This month, we illustrate why the cliché of 'buying the dips' has been a winning approach for long-term portfolios. The history of market dips reveals that unless fundamentals have decayed or a serious global crisis has occurred, investors often can buy good stocks (and sometimes bonds) at discounted prices resulting from external events that have little bearing on intrinsic value.

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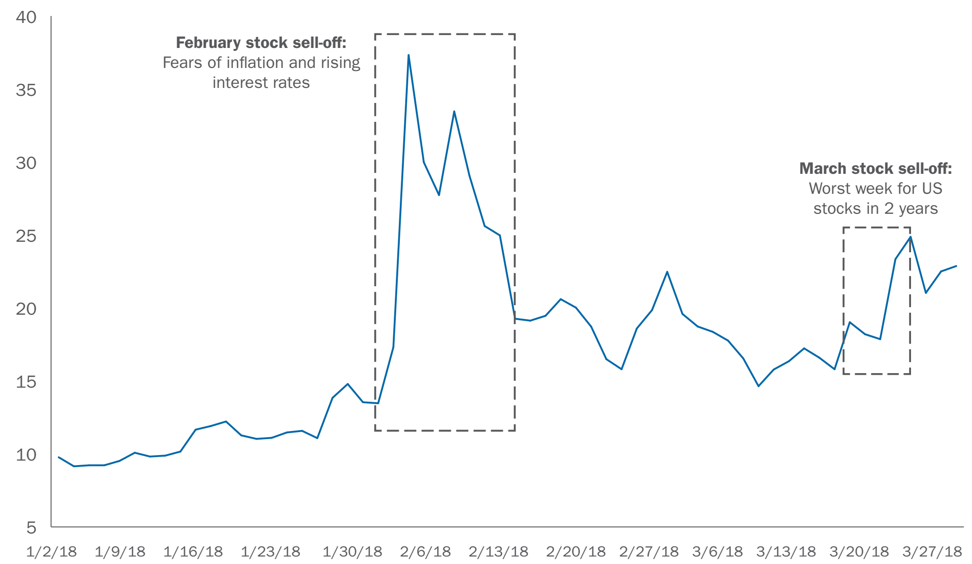
As we have noted and everyone has noticed, market volatility appears to be back, not as a blip but as a feature of markets just now. In the past month, multiple swings of more than 1% in domestic and global equity markets have occurred, and though bond prices have been less volatile, continued interest-rate tightening by the Federal Reserve (Fed) has made bond markets more prone to jumps.

The question then for investors is, what to do when markets move wildly and rapidly, based on a tweet or some new event that roils markets? The answer is to buy the dips. Period. Unless there is some clear indication of a market breakdown in bonds or equities, based on deteriorating fundamentals or a serious global crisis, investors indeed should rely on one of the more common pieces of market wisdom: Buy the dips.

It may be a cliché, but that doesn't make it less true

To be fair, advising people to 'buy the dips' does not rank as an original or unheard of piece of

Figure 1:
Market Volatility in Early 2018



Source: Yahoo Finance

advice. *Au contraire*, it is one of the great clichés of investing. But as is often the case, just because it's a cliché doesn't mean investors should ignore it. In fact, it's a cliché because of how often it works.

Charts of past dips are one indication of just how wise it might be to use market pull-backs as opportunities to build on current positions or allocations. Time and again, buying when stocks or bonds reset has been a successful approach. The reasons are fairly simple: Sharp market swings often are triggered not by a sudden deterioration of fundamentals but rather by external market events that bear only passingly on those fundamentals. As a result, price action reflects the sentiment of the day, and often the fears of the day, rather than the intrinsic value of a particular stock, bond, or asset class. And when prices diverge suddenly and sharply from fundamentals, that is frequently an opportune moment to reestablish desired weightings.

Of course, timing can be complicated, and as they say (you know, them…), timing is everything. It is far easier to identify dips in retrospect. While things are dipping, it isn't always clear how much more they will dip. There's a contrary market cliché of not trying to catch a falling knife, which cautions against buying something just because its price has decreased and it now looks attractive. 'Buy the dips' can assume too much certainty about when something has stopped falling.

That should be a caution but not a prohibition. Take the market retreat over the past month, in which most year-to-date equity gains have been wiped out. The pullback has been even more dramatic in the so-called FANG stocks—Facebook, Amazon, Google, Netflix—that have led the tech sector in particular to new highs. Those names have pulled back as much as 20% or more (Figure 2). Yet the fundamentals of none of them have changed dramatically.

Figure 2:
FANG Stocks: Dramatic Pullback in 2018

Stock	YTD return	1-year return
Facebook (FB)	-11.53	9.72
Amazon (AMZN)	19.03	56.15
Netflix (NFLX)	47.78	93.08
Google (GOOG)	-3.15	20.85

Source: Morningstar. Daily returns are YTD from 1/1/18 to 4/3/18 and 1-year from 4/3/17 to 4/3/18.

Yes, Facebook is confronting severe hits to its image and potential challenges to its business model of monetizing user data. Netflix has been on a spectacular run but trades at heady valuations. Amazon seemed to be on the verge of becoming

a trillion-dollar company and then was challenged by President Trump, who has some animus for the company and its CEO founder, Jeff Bezos (who personally owns the *Washington Post*). But the sharp correction had less to do with new information about how these companies are performing commercially and financially and more to do with market fear, profit-taking, and a high-flying sector undergoing a normal, albeit painful, reset after a very strong run.

Does that mean one should now plunge back in? The ‘buy the dips’ adage is best served for sectors and asset classes rather than for individual names, unless investors are doing intensive and consistent fundamental analysis at the company level. The FANG stocks, along with Apple and Microsoft, are sufficiently large to form a significant percentage of the NASDAQ (Google/Alphabet, Amazon, Microsoft, Apple and Facebook account for nearly 30% of the NASDAQ Index), so any investment in either that Index or the Information Technology sector means increasing exposure to those names. But it also means exposure to many other companies, which somewhat dilutes the stock-specific risks that increase with individual companies. Any company can lose massive value more easily than an entire sector or asset class.

‘Buy the dips’ also does not usually mean buying all at once. If an investor determines that a pullback is less about fundamentals than momentum, news, or a market rotation, then buying as and when prices fall should be a modest and gradual process for most investors and their portfolios, especially given the extreme difficulty of knowing just when a pullback is over. Even so, time and again, using those dips as an opportunity to increase exposure tends to work over the long haul, unless they are triggered by sharply deteriorating fundamentals.

Hence, buying financial stocks in mid-2008 was not a wise move, given how much the financial industry was teetering on a precipice of poor fundamentals. Had investors bought the XLF in mid-2008, after it had fallen from its 2007 highs by more than 40%, it would have been five years, in 2013, before they would have gotten back to that point. Only if they had waited until March of 2009 would they have caught the bottom. The sector collapsed because of poor fundamentals, and hence only when the entire sector finally reset to adjust to that could they have invested successfully.

The key, then, is distinguishing between a dip that is triggered by money rotating or externalities (an errant tweet, for instance) and one triggered by

Figure 3:
Market Volatility In Early 2016
VIX, December 2015 to April 2016

Source: Yahoo Finance

decaying fundamentals. That is easier said than done, and it requires looking at the underlying causes of dips when they occur to determine whether buying is indeed the right approach.

And now?

For the moment, it seems as though the recent market pullback looks more like what happened at the beginning of 2016 than what happened to financials in 2008. It looks more like a price reset and a general market pause around the uncertainty of interest rates and Washington policy than a harbinger of poor fundamentals. Second-quarter earnings appear to be strong, which may allay concerns of something fundamentally broken, and might offer some solace and confidence that these are dips worth buying. On the flip side, as the Fed continues to tighten, there is no indication that bond yields have stopped rising, though the rise is hardly sharp. There are good reasons to own fixed income, but the case for price action and dip buying for fixed income is not as strong right now. ■

March/April Takeaway:

'Buying the dips' may be an effective strategy for investors to take advantage of the return of equity market volatility. Recognizing that it may be difficult to know when a pullback is over, advisors should first examine the underlying causes of a dip before taking action. Caution is in order: A lower price is no guarantee that a stock has stopped falling. That means distinguishing between dips caused by externalities (such as momentum, news, or Washington's beltway blips) versus deteriorating fundamentals. Buying gradually during the dips can be a strategic move, and tends to be an approach that is more effective over the long haul. However, the case for 'buying the dips' in fixed income is not as strong at this point, as the Fed's pending rate hikes will put pressure on bond prices.

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