Averaging Down

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Let's assume you buy a stock at $100 (thinking it's worth $150) but the stock drops to $70. Do you:

1. Buy more and average down
2. Cut your losses and sell
3. Hold

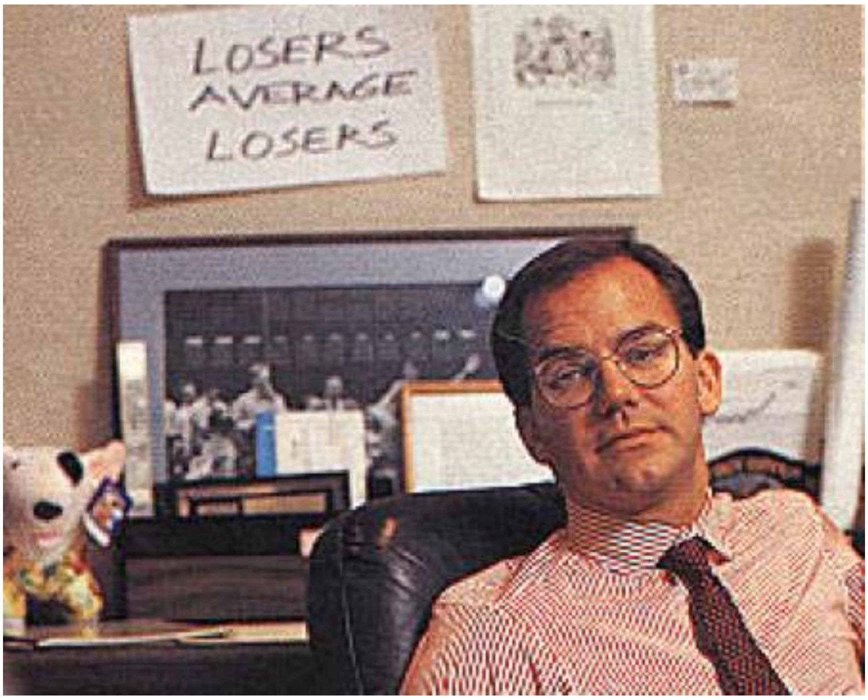
There is no correct answer to the question above because it all depends on the situation. Sometimes a fall in the stock price is a gift – it allows you to buy something you really like at a discounted price. Making the right call in these types of situations is what separates the best from the rest.

But, the common approach is to buy more at the lower price. After all, if you like it at $50, you should like it even more at $30. Averaging down makes sense because it lowers your average purchase price and breakeven point. Even Warren Buffett has successfully averaged down on many occasions.

However, averaging down can sometimes be a mistake and lead to large losses. This desire to average down and recoup losses stems from many psychological biases such as:

- Over-confidence
- Anchoring
- Denial
- Consistency & Commitment
- Sunk cost
- Loss aversion

It's awesome to average down when you are right. Not so much when you are wrong. My advice would be to think carefully before averaging down on highly levered and poor quality businesses. Also, make sure that there hasn't been any significant impairment in the value or earnings power of the business.



Paul Tudor Jones

Averaging Up

One of the most counter-intuitive ideas in investing is averaging up. Many investors avoid buying into businesses whose stocks are trading at an all-time high. Sometimes, investors refuse to buy more shares at prices above their historical cost (called anchoring bias), even though the intrinsic value of the business has gone up even more.

The reality is that sometimes stocks of great businesses may be cheaper and more attractive at the higher price. For example, when you first invested in the business, it may be small and risky. But, as a result of brilliant execution or a transformative acquisition, the expected return over the next decade may have become very attractive again.

> *It is that the stock they own has had a huge advance. Therefore, just because it has gone up, it has probably used up most of its potential. Consequently, they should sell it and buy something that hasn't gone up yet. Outstanding companies, the only type which I believe the investor should buy, just don't function this way.*

-Philip Fisher, Common Stocks and Uncommon Profits