Buy Into Weakness – Investment Rule #1

Over the course of the coming weeks and months I will be laying out the investment rules that I live and die by. These are rules that I have developed over the last ten years as both a retail and professional investor and trader:

Rule # 1: Buy into weakness.

Rule #2: Sell into strength.

Rule #3: Reduce cost basis.

Rule #4: Keep investments small.

Rule #5: Keep 80% of total invested capital in ETF's and up to 20% in individual names.

Rule #6: Choose duration over direction.

Rule #7: Manage your winners.

Rule #8: Manage risk at order entry.

Rule #9: Increase your # of occurrences.

Rule #10: Make investments with a probability of profit > than 50%.

(Note: I will come back to this post and create hyperlinks as I cover the different rules in future posts, however I would highly recommend that you join the email list in order to receive new posts delivered right to your inbox. I don't want you to miss this).

One thing that you will learn over this series of posts is that I love to trade options. More specifically I love to sell option premium. My overall goal after I cover all 10 of my rules to investing and trading the financial markets is to show you how you can reduce your risk, increase your probability of profit, and give yourself more than one

way to win. Too many people out there have bought into the notion that options are too risky and that they are too advanced for most investors. The truth is that risk is a function of education, and I want to educate you and show you how options can play a vital role in your portfolio. I am actually going to teach you how options can reduce your risk (by reducing your cost basis) and give you an edge in a market where most retail investors have none.

Let's first cover the first rule.

Rule #1: Buy into weakness (i.e. get long)

This simple rule says that we buy investments in equities on days when they are down in price. And if you were selling an investment, you would sell into strength (rule #2, but we will cover that in the next post of the series).

For most people who have ever made an investment or trade in the financial markets, buying into weakness appears to be a huge mistake and can even be scary. What if it keeps going lower? That doesn't seem to stop people from holding onto investments that once were headed higher anyways…

The herd mentality is that you buy into strength, which typically leaves retail investors regretting ever getting into the market at all. The average investor buys the top and sells the bottom (it's sad but true). That's because humans are not innately wired to invest. You have no edge in the market if you just do what the average person does. And no one reading this wants to be average right???

I am about to pose some very contrarian views on how and when to get long equities, or any asset class for that matter. I will forewarn you that these views will

go against all conventional wisdom you hold to be true.

3 Universal Truths That Don't Get Talked About Much

1. There is only one way to win (make money) when you buy an equity (assuming no dividend of course). You only make money when an equity increases in price.
2. An equity has 2 directions it can move: Up or Down. Of course when the market is closed it doesn't move at all.
3. The direction of a stock has a 50% chance of going up and a 50% chance of going down on any given day, week, month, or year. Although due to a log normal distribution, the markets typically go up over time. I think something like 70% +.

So the question we need to answer is **what can we do to gain an edge and thus increase our probability of a profitable investment? Because let's be honest with ourselves, there is no such thing as a guarantee.**

The simple answer that is probably a lot easier said than done is to "**buy low and sell high."** If you haven't heard this mantra, you have probably been stuck between a rock and a hard place up until you found this blog. The reason this is so hard to do is due to the natural apprehension to buy stocks when they have decreased in value. The stupid money (being the average investor), has this ridiculous idea that stocks that are going up will go up forever and stocks that are declining are likely going to zero.

Ok, so maybe that is extreme. But I am sure you can partly relate to that. This is the kind of thinking that drives the whole fear and greed cycle.

I strongly urge you to get over your apprehension to buy into weakness (i.e. when a stock is down in price). This is one way to reduce your cost basis and increase the probability of profit (in a future post we will talk about other ways to reduce cost basis even further). This is not the same as timing the market, instead you are patiently waiting for more favorable prices. And as we get deeper into this series you come to realize that down days are the best days to sell option premium…but let's not get ahead of ourselves.

Think of it this way:

Warning: This is a very extreme and simplistic example to more clearly illustrate my point.

Example 1 – Your friend buys Apple stock as it is making all-time highs around $750/share (pre-split). The media and Wall Street have been hyping this stock to be the first trillion-dollar company. He just couldn't miss out and had to buy before it was too late and he missed the move.

Example 2 – You are interested in the stock but unlike your friend, you want some margin of safety (something Warren Buffet looks for in all his investments) that will increase your probability of profit (or at the very least reduce your downside risk, because all investments have downside risk). So you decide to wait for a pull-back. Apple disappoints on earnings and over the course of the next 15 days the stock declines 20%. With the stock now trading down $150 from its all-time high of $750, you buy Apple stock at $600/share.

Who has a better chance of making a profit? You or your friend?

YOU DO!!!

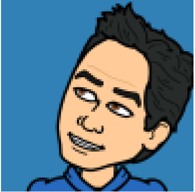
Your friend needs Apple to rise in price by 25% just to get back to even after losing $15,000 for every 100 shares of stock. If it rises 25% from your purchase price, well you make 25%.

The Takeaway Lesson

The person with the lowest cost basis always has a higher probability of making a profit on an investment. It is simple math. The lower your cost basis, the lower an asset has to move in order for you to make money.

Now obviously you still want to make sure the companies that you are making investments in are solid companies. Sometimes companies are cheap for a reason (that's why you always do your homework). This is also why I use ETF's in 80% of my investment activities in the stock market (will cover this in a future post as well). All that I will say now is that ETF's remove the binary risk you get from individual stocks from things like earnings announcements, take overs, CEO scandals, etc.

– Gen Y Finance Guy



Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More