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Buy late and sell early.

Posted in Investment strategy at 1:02 pm by ChineseCycles

Sometimes readers ask me: "When to buy and when to sell?"
It is the million $ question if you are into stock market investing.

Most common answer to that question is : "Buy low and sell high"
That makes sense.
But you will need some tool or approach that tells you when prices are low or high. And that is not so easy.
We have only moved the problem and now the question is : "What is high and what is low?"

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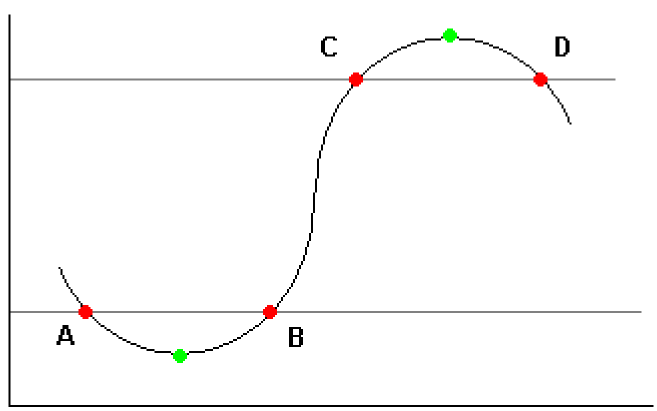
My own answer to the question is a bit different.
I try to "Buy late and Sell early"
Let me explain why.

Here is the idea:
Suppose a market or stock is on the way down and we are looking to buy it.
Obviously it will probably bottom sooner or later, and start going up.
To buy exactly at the bottom price will be very difficult and probably require a good deal of luck.
So in practice we will either buy before the actual bottom or after it, there are no other ways.
Here it is put in an idealized picture:



Market goes down, bottoms and turns upward.
In practice it will be no more difficult to buy in point A than it is to buy in point B.

We get a very similar situation whenever we sell and take our profits.
Catching the exact top will be rare.
It will be no more difficult to sell at point C than at point D in this picture.

So we get a number of different possibilities here:
1) Buy in A, sell in C (buy early, sell early)
2) Buy in A, sell in D (buy early, sell late)

3) Buy in B, sell in C (buy late, sell early)
4) Buy in B, sell in D (buy late, sell late)

In all 4 cases the investor makes exactly the same profit, but case 3 (buy in B , sell in C) is far better because this investor makes the same amount of money in a much shorter time.
While the other investors have their money locked up because they bought too early or waiting too long, this investor #3 can meanwhile make money in another stock or simply earn interest in the bank.
There are so many different markets and stock that there are always new opportunities..

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But that's not the only advantage of buying late (B).

Sometimes there are several months (or even years) between point A and point B.
The person who bought early (A) is often getting tired or frustrated by the time this stock bottoms out, and maybe he shows a paper loss of 10-20% on it.
So, being tired, he may be all too happy to get rid of it at breakeven price when point B is reached.
Next it goes from B to C in a matter of months and this investor will be kicking himself.
This happened to me many times, till I learned to buy late.

The second advantage of buying late (B), is that you have an objective criterion to decide that your trade is wrong and get out.
If you buy late (after some bottom), but next the stock moves to fall even lower, then you know that you bought too early, hence it was a wrong trade and you can probably get out at a relatively small loss.
The investor who buys early (A), does not have an objective yardstick to decide when his trade is wrong. He goes on thinking that the bottom must be near, and before long the losses mount to 20, 30 or 50% or more…
Eventually this poor fellow sells in pure disgust, and that turns out to be very close to the bottom price for that stock.
Sounds familiar?

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About the selling early (C), some people will object that you may miss out on a significant portion of profits with this approach. Sometimes a stock keeps going up for years and you may have sold it after 3 months already…
Well, that's true and some investors who can wait till after the peak may sometimes realize a much greater profit.
But they will also have waited a lot longer for it, so they are not necessarily beating investor 3 who likes to leave the ship early.
It is smart to decide early on if you are buying for short, intermediate or long term; then stick to your idea.
That usually solves the question whether you want to take the profit after 3 months or after 3 years.

And there is one major disadvantage to selling late (D) approach.
The stock reaches a peak, then falls to point D level.
Not rarely the investor will decide to sell, but secretly hopes that the stock will first climb back to near the peak level and then he will sell it. Getting greedy…
And the stock doesn't climb back, and soon it is well below the level D, if not all profits wiped out..
This investor typically ends up (angrily) selling at breakeven level too.
He made a good trade, had a nice profit, but could not move himself to sell when it was the time to sell.
Selling late (D) approach is good only if you have the mental fortitude to sell on the way down, sell below the top.
Otherwise just chose sell early (C) approach, and do not calculate the extra profits you would have made if…

Just be happy if the person you sold to can make some profit too…

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It is purely a question of your personality style.

If you are a very patient type, then you may even succeed with a buy early (A) approach.
But most people are not that patient.
If you are a very disciplined person, then you may be more successful with a sell late (D) approach.
But most people are not that disciplined.

Buy late and sell early is the most practical for a lot of people.
With a reasonable good timing tool you can succeed.
Personally I use the Chinese Cycles for timing, but this approach can be useful with any type of timing tool.

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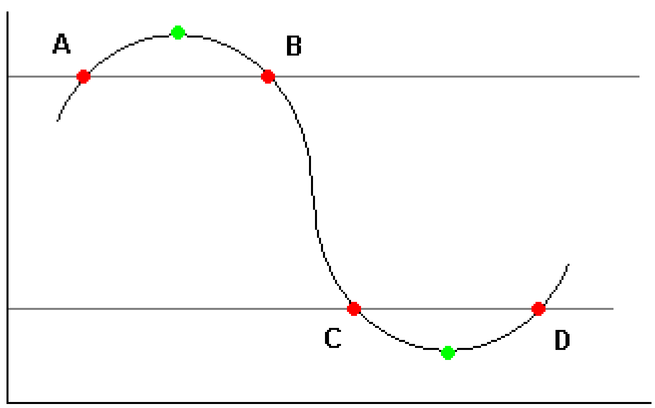
As a final note:
If you like to play the downside (short) of the markets, then it turns upside down.
As a short seller you try to sell late and buy (back) early.
Here is the picture for short selling.
You sell at B and buy at C.
The reasoning is exactly the same so you can work it out for yourself



Good Luck.

Danny