Seeking Alpha

Education > Investing

'Buying The Dip': What It Means & How To Do It

Updated: Jan. 10, 2024 | By: Richard Lehman

Table of Contents

“Buying the dip” is a phrase that describes investment strategies designed to take advantage of periodic drops in stock prices. Learn what buying the dip means and how traders do it.

colleenbradley/iStock via Getty Images

What Does It Mean to 'Buy The Dip'?

"Buying the dip" refers to the act of buying stock (or adding to positions) on a decline that meets certain parameters. A simple parameter might be to purchase when a stock or the broader market index has dropped more than a certain % from a recent peak. (This scenario is depicted in the example below.)

There is a natural tendency for some investors tied to loss aversion bias that causes them to get nervous and consider selling when stocks begin to decline, despite the fact that minor declines are common occurrences, even within long uptrends. For these people, *buying the dip* would represent a mindset of affirming longer-term objectives.

Dollar Cost Averaging / Averaging Down

The investor tactic of Dollar Cost Averaging (DCA) is closely related to the strategy of buying the dip.

Dollar Cost Averaging involves adding additional shares to an investment position already owned, purchasing these when the market price drops. This tactical move can lower the breakeven level of a holding and position the portfolio for greater profits if the original investment thesis comes to fruition.

For example, consider an investor who previously purchased 200 shares of XYZ at a price of $14, for a cost of $2,800. Let's assume that XYZ reported poor results, and the shares have dropped to $11. If the investor still holds confidence in the long-term prospects for the company, they might add another 100 shares of XYZ for a cost of $1,100. This would mean they now hold 300 shares of XYZ, at a total cost of $3,900. The average price paid for the shares has now dropped from $14.00/share to $13.00/share, meaning the investor has achieved dollar cost averaging.

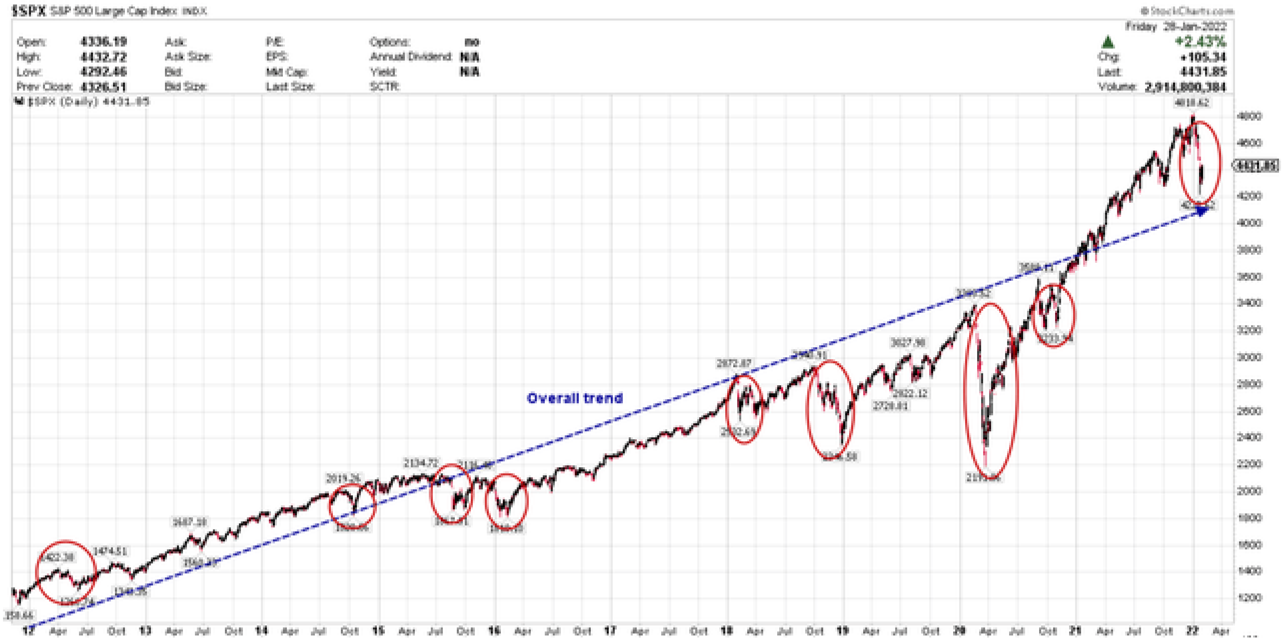
'Buy The Dip & Sell The Rip'

For someone who is looking to trade or invest in concert with market cycles, buying the dip would just be one part of the strategy—acquire stocks in or near the trough in the cycle. The other part of the strategy—“sell the rip”—refers to selling stock at an assumed peak in the cycle. To "buy the dip and sell the rip" describes a complete timing strategy for an investor who is interested in trading the cycles.

> ***Warning:*** *Many experts caution that very few investors benefit from trying to time the market.*

Example of Buying The Dip

The chart below shows the S&P 500 index over the last 10 years with red circles indicating the periods where a 10% decline had occurred. An investor who was buying 10% dips would have purchased when the market was down 10%. This would have generally proven beneficial for most of the last 10 years, but there's never any certainty that the downward trend won't continue beyond the loss of 10%. For example, the S&P 500 fell by more than 30% between mid-February and mid-March 2022, as the world came to terms with the severity of the COVID-19 pandemic.



SPX 10-year chart
StockCharts.com

> ***Tip:*** *Buying the dip should be associated with a patient, long-term approach to stock investing. Trading market cycles should be a strategy for short-term or swing traders who have analyzed various techniques and who are prepared to trade based on disciplined indicators.*

Understanding Market Cycles

To understand the "buy the dip" strategy, it's important to first understand *market cycles*. Neither individual stocks nor the market as a whole move in straight lines—both tend to move up and down over time within longer-term trends. Charles Dow, the founder of the Wall Street Journal and the indexes that bear his name, was one of the first to describe stock market cyclicality over 100 years ago.

Since that time, market technicians have attempted to use a variety of market cycles, patterns, and technical indicators to devise trading techniques that could outperform the market by taking advantage of such movements. The objective is simple: to enhance overall market returns by purchasing when a stock or the market is at a cyclical low point and selling when the market is at a cyclical high point. In reality, however, the ability to outperform the market in this manner has proven to be much more elusive than people thought and much debate has ensued as to its merits.

Part of the challenge is defining and quantifying market cycles, as there are many different versions that are used. There is the:

- **General business cycle:** varies from expansion to contraction in the overall economy
- **Four-phase cycle:** accumulation, markup, distribution, and decline

Others have defined market cycles in psychological terms describing vacillations in terms of repeating periods of panic and euphoria. In addition, there are:

- **Wave-based cycles**
- **Calendar cycles**
- **Sector rotation cycles**
- **Presidential cycle**

In sum, there are as many different ways of buying the dip as there are different types of cycles and no universally accepted way of identifying the frequency, magnitude, or regularity of opportunistic dips in stock prices. This renders the term somewhat ambiguous and subject to the interpretation of the user. The growing popularity of passive investing through index funds speaks to the frustrations of many investors who have given up on trying to outperform the market by timing purchases and sales with any consistency.

How Long are Market Cycles?

As you might expect, market cycles differ greatly in their frequency and duration. Many take months or years to play out. That makes it quite challenging to know when a dip in price is presenting an attractive buying opportunity or when it is only the beginning of a longer cycle downward..

It is easy to look at a price chart, identify previous dips in price, and conclude that if you bought into those dips, you would have been able to get a leg up on the market as it rises again within the long-term trend. But that confidence comes from the perfect hindsight one has when viewing a price chart. On the occasions when those dips were occurring, you wouldn't have that knowledge and would constantly be faced with the dilemma of whether it was truly a good time to buy or whether the market was breaking into a longer-term downtrend due to persistent challenges.

Behaviors The Cause Market Cycles

Market cycles may not be regular or predictable, but there is little question that they are real and recurring and there are a host of proposed rationales for their existence. Some are based on economic theories about supply and demand or the natural ebb and flow of business prospects over time. Others are purely based on mathematics and calendar periods that have shown a propensity to correlate with the ups and downs of the market.

Nonetheless, the widely accepted premise for most cycles lies in the assumption that they are linked to the emotions of market participants or to cognitive biases such as fear of regret and overconfidence. Charles Dow's early observations likened the market to a barometer of the collective optimism or pessimism present among the investing public. More recent interpretations link the market to the degree of fear or greed present among investors.

'Peak & Trough' Metrics

Over the years, market technicians and cycle proponents have put forth hundreds of measures and indicators that investors can use to guide decisions about buying dips and selling peaks. No single indicator can be expected to provide an iron-clad assessment as to whether the market is at a peak or trough but taken collectively, they can often provide valuable insights as to whether the market is presenting an opportunity to buy or sell stocks at attractive prices.

Types of market indicators include:

- Economic indicators
- Price and momentum indicators
- Options indicators
- Volatility measures
- Demand for bonds over stocks
- Level of margin debt
- Sentiment indicators
- Technical indicators

CNN has created its own Fear and Greed Index from seven specific indicators, including:

- The S&P 500 versus its 125-day moving average

- The number of stocks hitting 52-week highs and lows on the New York Stock Exchange
- The volume of shares trading in stocks advancing versus those declining.
- The options put/call ratio
- The spread between yields on investment-grade bonds and junk bonds
- The VIX, which measures volatility
- The difference in returns for stocks versus Treasuries

Bottom Line

Buying the dip is a strategy that attempts to capitalize on the understanding that stocks move up and down in cycles, sometimes short-term, sometimes medium-term, and sometimes longer-term. Stock declines can serve opportunistic investors to buy the dip, lowering their entry cost (or average cost) into stocks they wish to own.

FAQs

What is 'the dip'?

The dip is a short-term decline inside a longer-term uptrend.

How do you determine when a dip is over?

There is no magic answer to this, but numerous technical indicators can be used to help determine the optimal buy point within a dip.

Is 'buying the dip' a good idea?

Buying declines within a longer uptrend can prove beneficial, but there is no guarantee and investors should not expect that the strategy will always be successful.

This article was written by

Richard Lehman

815 Followers

Follow

Adjunct Finance Professor at Cal Poly and UC Berkeley (20 yrs), author of three investment books, Wall Street veteran, and founder of Climate Economics. Helping people understand the financ

Show more

Comments (5)

Sort by Newest

If you type a company or ETF ticker symbol in capital letters we will automatically link to the symbol page. You can remove the link by deleting the $ in the comment.

Thomas Covenant
18 Nov. 2022, 7:37 PM

Premium Comments (172) | + Follow

This is a question to the author, but I appreciate any feedback. I only started using Fibonacci retracement in some of my small trading acquisitions and selling. What are thoughts on using this tool in trying to determine dips and highs? Do you think it should be used in conjunction with any other tools (outside of researching fundamentals and technicals)? Or do you use other tools together in trying to determine these values? Your feedback would be Ryals much appreciated. Thank you.

Reply Like

Richard Lehman
19 Nov. 2022, 9:31 AM

Analyst Premium Comments (35) | + Follow

Analyst's Reply *@Thomas Covenant* Honestly, I cannot point with confidence to very many specific methodologies that consistently work for buying dips or selling highs. People use a wide variety of technical tools for doing so. Also, my behavioral work suggests that it is futile to expect that there even is a mathematical formula that could reliably do so. When people like Warren Buffett buy dips, he is actually focusing more on long-term fundamentals than short-term technicals.

That said, the person I respect the most for his work on short-term trading is Larry McMillan (OptionStrategist.com). Larry uses indicators such as VIX to predict short term market movements. His work is sound, consistent, and mathematically-derived.

As for fibonacci relationships, my opinion is not kind. There are so many of them, that when one doesn't appear to work, proponents simply assume the next one will. That makes trading off them an entirely futile process.

Reply Like (2)

Thomas Covenant
18 Nov. 2022, 7:25 PM

Premium Comments (172) | + Follow

Thank you for the reminder of being careful when trying to determine when to buy on dips or the lows a stock can go. Even 20% down doesn't hold up very well into today's insanity. Too many people in this market never look at fundamentals and technical metrics. Price seems to be as far as their research goes. Eventually the bear will hibernate and the bull will reappear, but right now I'm seeing the bull square in his eyes.

Reply Like

User 50563992
05 Nov. 2022, 3:23 AM

Comments (2) | + Follow

It means when the fear is around you need to buy. When people become greedy you need to sell quality stocks too.

Reply Like (1)

Thomas Covenant
18 Nov. 2022, 7:26 PM

Premium Comments (172) | + Follow

@User 50563992 Yup. Buy on the dip and sell on the rip.

Reply Like (1)

Disagree with this article? Submit your own. To report a factual error in this article, click here. Your feedback matters to us!