Building Pyramids

By Jonathan Hoenig
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LET'S SAY YOU want to buy XYZ. Maybe it announced better-than-expected earnings or crossed a key moving average. Perhaps you are watching a similar company or index move and expect XYZ to follow along. Maybe you used the company's products or read some compelling research. As Rod Stewart sang, we all need a reason to believe[1]. Whatever your reason, you believe. Fine. Two sides make a market, and nobody knows the future. If you are bullish on XYZ, then it's time to buy XYZ.

What messes most people up isn't what to buy, but how. Having a good investment idea is a start, but putting it into practice is another thing altogether. And while a sound trading technique won't prevent you from losing money, it will keep your losses small and the majority of your capital focused on the most profitable ideas. No trade is without risk, but the difference between risk and recklessness is proper procedure. Trading is like any fine art: There *is* such thing as objectively good form.

The oldest — and the only surviving — of the ancient Seven Wonders of the World are the Egyptian Pyramids[2]. Their longevity is due, in part, to inherently strong design. The majority of a pyramid's mass rests at its base, closest to the ground. A much smaller portion of the material is used near the top. The setup creates a uniquely stable architectural footprint.

What do pyramids have to do with portfolios? Just like the base of a pyramid, your initial position in a company should be your largest — depending on the volatility of the security and your tolerance for risk, anywhere between 2.5% to 5% of your portfolio. What stocks you pick matters less than the size of your commitments relative to your overall portfolio. If I've taken a position, it's because I think it will become profitable. After all, if I'm not enthusiastic about my positions, then I probably shouldn't have them in the first place. But no trade is without risk, so I need to be confident, not cocky. By limiting my initial purchase to no more then 5% of my overall portfolio, I am keeping the stakes relatively low. Even if XYZ goes to zero right after I've bought it (unlikely for most securities), I've lost only 5%. This way, you can afford to have bought the top (or sold the bottom) and still live to tell about it.

When you buy a stock, only one of three things can happen: It can move higher, showing you a profit; it can move lower, showing you a loss; or it can move nowhere in particular. As I wrote[3] a few weeks back, most of trading is watching, not trading. So after I put on my initial position, I don't listen to the pundits[4], but the market itself. I watch the action, not the analysts. A winning trade is usually profitable right off the bat.

The Pyramid Scheme

Market Price	# of Shares	Cost	Average price of entire stake
$51	100	$5,100	$51.00
$52	75	$3,900	$51.42
$53	50	$2,650	$51.77
$54	25	$1,350	$52.00
$55	12	$660	$52.13
$56	7	$392	$52.24

Total: 269 @ $52.24 = $14,052

Market Value: 269@ $56 = $15,014

But because I often am, let's first assume that I'm dead wrong[5]. I buy 100 shares of XYZ at $51, not knowing that it will prove to be the all-time top. The stock gets killed. First the company misses its earnings projections, then the top management leaves. Brokerages downgrade the stock and even loyalists throw in the towel. XYZ declines by 50%. I was wrong. Assuming I bought a 5% position, I've bought a 2.5% tax loss. My ego has been bruised more then my portfolio. I'd probably take the loss, revisit my analysis[6] and keep watching.

What I won't do, however, is something too many traders do: double down. If I buy 100 at $51 and 100 more at $26, I'm long 200 shares (now more than 10% of my overall portfolio) at an average cost of $38.50. With the stock at $26, it still has to climb 47% for me to get back to "even." It could happen, but not without me putting an inordinate amount of my capital into a trade that isn't working out to begin with. The point isn't to be right, but to be profitable.

Conversely, let's assume that my analysis was correct, and after I buy 100 shares of XYZ at $51, the stock moves to $52. I've got a winner on my hands, which is what we want. Ironically, it's also where most people start getting into trouble.

Contrary to the trader stereotype, I'm not simply looking to buy before Regis[7] and sell after Rosie[8]. I don't want to be in stocks for minutes, but months. So despite the human instinct to make the cash register ring when an initial position becomes even marginally profitable, it's a sign to *increase, not decrease,* your exposure. When a stock moves up from your purchase price, it's telling you something: You were right.

Most people cut themselves out of winning positions way too early because they want to feel good about having cashed a ticket. But the stock is not psychic. It doesn't "know" I bought it down at $51. So if I've bought 100 shares of XYZ at $51 and the stock moves to $52, I'll add another small position, let's say 75 at $52. Now I'm long 175 shares, almost double my initial commitment, at a below-market average price of $51.42.

And if I liked it at $51 and $52, you can bet I'll like it at $53. I'll buy another 50 shares. And 25 more at $54. Add another 12 at $55, another 7 at $56 and so on. My position is expanding, but so are my profits, as the table shows. I am trading with the trend and focusing my capital on winning ideas. I'm riding the wave, not fighting it.

If the name of the game is "buy low, sell high[9]," you might ask why I don't simply sell the stock as soon as it shows a profit and move on to another trade. After all, don't traders buy and sell quickly, jumping in and out for the quick buck? As we all know, it's tough to pick winning stocks. Many trades just won't work out. So when I am fortunate enough to be right once in a while, my interest isn't taking quick profits, but maximizing the earning potential of my positions.

With XYZ at $56, I'm up a little less than $4 a share on paper. But I'm really up more. Why? *I've got a winner!* I have a healthy-sized position at a low average price of $52.24 a share. XYZ has already trended higher and caught the interest of new longs. There are a million people thinking about getting long at $56. They'd love to trade positions with me and have bought a big block back at $52.

It costs money to get into a good position, namely commissions, time and the small losses you've taken on other trades. The point isn't that every trade is a winner, but simply that your biggest positions are your winning positions. When you've got a winner, especially in a solidly constructed pyramid, you're in a good position — don't just give it away.

It's a tough world out there, and only after leaving several quarts of blood on LaSalle Street[10] did I begin to realize that good technique, namely money management, is what the game is all about. By staggering my purchases in a pyramid, I've bought comparatively few shares at the market's current price, so even a sharp retracement back to 53 won't knock me out of the game.

So now that we've touched on the basics of trading a position, we'll talk about the various positions, and how to begin assembling a portfolio, one week from today.

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[1]http://www.letssingit.com/lyrics/s/stewart-rod/4.html
[2]http://www.pbs.org/wgbh/nova/pyramid/
[3]http://www.smartmoney.com/tradecraft/index.cfm?story=20010322
[4]http://www.smartmoney.com/pundits/index.cfm?story=method
[5]http://www.jacobinternet.com/manager.html
[6]http://www.smartmoney.com/tradecraft/index.cfm?story=20010315
[7]http://tvplex.go.com/buenavista/livewithregis/index.html

[8]http://rosieo.warnerbros.com/pages/rosieo/home.jsp
[9]http://www.smartmoney.com/consumer/index.cfm?story=200012221
[10]http://www.cbot.com
[11]http://www.capitalistpig.com