Get Rich Safely With This Sound Dip-Buying Strategy

Description

Buying the dip is a terrific strategy to use in a bull market if you've done your homework well in advance. Seemingly negative announcements, events, or underwhelming earnings reports can cause sudden and sharp dips in share price and oftentimes, such dips may be overblown, as many investors simply choose to exhibit the "sell now, ask questions later" mindset.

Why event-driven dips may fall too far

The "sell now, ask questions later" attitude is incredibly rash and emotion-driven. And given that such a negative event is already baked into the share price, such panic sales would, more often than not, destroy an investor's longer-term returns.

Moreover, sharp event-driven declines tend to cause many weak-handed investors to rush for the exits because they're not sure what to make of the recent negative development. Typically, the barrage of negative headlines that follow a negative event further exacerbate the fears and cloud the judgement of investors, resulting in huge declines that are more often than not overblown. Such action-inspiring headlines may cause investors to take action, when in reality, the best course of action would be to sit and do nothing!

After the dust has settled, many stocks on a dip may stand to correct to the upside after the general public has had the opportunity to digest a recent negative event. Long-term investors who are confident in their investment homework on a particular stock should thus have no hesitation when pulling the trigger on such a stock on the dip, as these upside corrections are an added bonus that comes with effectively buying on the dip.

Such upside corrections may not happen immediately. In fact, they may not happen at all! That's why it's incredibly important to have confidence in your long-term thesis when buying on weakness. If the dip continues to happen prior to your purchase and you're not feeling even more euphoric about the possibility of buying more at lower prices, then you should probably reconsider your confidence in your long-term thesis before hitting the buy button a stock that's dipped.

When not to buy the dip

Buying any stock on the dip, although a popular strategy among many value-conscious investors is not without its risks. For instance, buying some arbitrary stock on the dip because it seems “cheap” is not an effective strategy and may be just as reckless as panic selling a stock after a dip.

One must exercise due diligence to ensure that the long-term thesis of the underlying company is still intact and carefully consider whether the dip-inducing event has the potential to evolve into something more insidious over the longer-term. Short-term issues, if not carefully addressed by a company’s management team, can grow into longer-lasting issues and could hurt a long-term thesis.

To buy or not to buy?

Consider the recent dip in the shares of **Air Canada** (TSX:AC)(TSX:AC.B), where shares have fallen ~21% from peak to trough in recent months thanks in part to higher fuel costs and a greater number of expenses on longer-term initiatives including the insourcing of the company’s loyalty program. The ~$6 billion in long-term debt is also a cause for concern for many investors, as fellow Fool contributor Ryan Goldsman pointed out.

While the recent turbulent times at Air Canada may be indicate a sustained move to lower levels, investors must realize that shares are already dirt cheap at just 3.46 times trailing earnings. Even under the assumption that fuel prices remain high, shares are still absurdly undervalued, which in turn leaves me to believe that shares possess a margin of safety at the low $20 levels.

With no signs of an economic downturn on the horizon, I think Air Canada’s still poised to fly much higher from here, especially after the cost-savings from recent initiatives begin to take effect. In addition, Air Canada’s low-cost carrier Rogue may serve as a near-term catalyst that could cause the stock to correct to the upside.

The longer-term prospects look bright, so for those who are able to see beyond the recent spike in expenses, shares definitely look like a must-buy on the recent dip.

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