Pyramiding – Commonly Misunderstood

When I first began teaching this money management method, people queried whether I was pyramiding. This arose from a misunderstanding of what pyramiding is.

Pyramiding is a method of increasing a position size by using unrealized profits from successful trades to increase margin. Source: http://www.investopedia.com

When the definition of pyramiding is properly understood, I could only be pyramiding if I was investing on margin. I never borrow money in any way to invest, let alone take out a margin loan or use derivatives. Therefore, I cannot be pyramiding, by definition.

The common misunderstanding that what I do in phasing into an investment position is pyramiding takes two forms:

1. Some people thought that building a position in a stock in three steps was pyramiding. This misconception comes from a long-established investment principle that each additional purchase in building a position should be smaller than the one(s) before it. This is not pyramiding in itself. It is simply an associated idea that is designed to avoid the breakeven point on the whole position being too close to the last purchase price, which is most important when investing on margin.

2. Others thought that, because my capital may have increased between the first and later purchases in building a position in a stock, I was pyramiding. This misconception is close to the real meaning of pyramiding, but has one serious problem. Although the value of my first purchase in a stock may have risen, I cannot invest those unrealised profits by buying a second lot of that stock. Reinvesting unrealised profits in the form of increased margin that becomes available is a central idea in pyramiding. I do not invest on margin, so my unrealised profits cannot be used for pyramiding.

So, what I do is to build a position in a stock in stages to minimise risk. That is not the same thing as pyramiding.

Here is a longer explanation in answer to a question from a reader:

Reader's Question

Your entry tactic: invest an initial 2% then add another 2% etc. This is effectively pyramiding a trade as I can interpret. Have you considered going 3%, 1.5%, then 0.75% to reduce the chance of an increased loss if the more expensive shares (2nd or 3rd trade) are sold at a loss if the price should drop? That would effectively reduce the specific risk that is possibly occurring

My Response

My approach is to enter a position ideally in three stages. When I buy into a breakout, it means one third on the breakout, one third on the subsequent correction and one third on a new high for the now evident trend. When I buy into an existing trend, it means one third on a new high for the trend, one third on the subsequent correction and one third on a new high for the now confirmed trend. This is a three-stage entry to a trend. It is not pyramiding. Let me explain the difference.

Pyramiding is defined as using unrealised profits … as security to borrow funds to buy … additional positions. (Edna Carew *The Language of Money*)

Pyramiding is most common in the futures markets. Using a margin, a position is purchased. If the contract rises in price substantially, the balance in the margin account grows to the extent of the paper gains. If the margin account grows sufficiently, there will be enough there to enable the speculator to buy another contract. This continues so long as the price of the contract continues to rise, with more contracts being purchased using the paper gains as margin for the new positions.

To the extent that my position size calculations reflect any growth in the size of the portfolio when I buy the second and third parcels, there is a very small element of reinvestment of paper profits. However, it is nothing like the enormous leverage being used in true pyramiding.

Pyramiding is the explicit use of leverage and I do not use any leverage in my investment plan by choice. I do not choose to do so because there is quite aggressive assumption of risk in other areas of the plan as explained in my book.

The variation on my entry strategy you suggest is exactly what you should do if you were pyramiding. But I am not pyramiding, so I don’t think it is that relevant.

What I am doing in my investment plan is buying a breakout. Then as the trend I expect to unfold provides evidence that I am right in my expectation, I build my position. I do this because many breakouts fail, so it is a risk management tactic.

That said, there are many ways to make money in the markets and each of may arrive at different methods of managing the various risks involved in investing. If you think it is the way with which you would be more comfortable, that is fine. I suggest you test it on past data for many stocks and if it seems to work for you, build it into your investment plan. Each of us is different and we will balance the range of risks differently to suit who we are.

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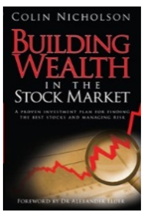

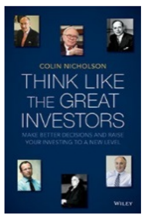

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