CASE STUDY (DG):
Determining When Mr. Market is Being Irrational + Multiple Reasons to Enter a Trade

The following case study was adapted from a 2017-08-04 Leveraged Investing Club post . . .

EXITED EARLY - (1) DG August 18 2017 $70 Short Put

(Entered @ $69.86; Exited @ $74.87)

Mr. Market is frequently irrational, but unfortunately, he's not completely crazy (it would be easier for us if he were).

Or as Hamlet would say, "I am but mad north-north-west. When the wind is southerly, I know a hawk from a handsaw."

Of course, that sounds suspiciously like something a crazy person might say to try to persuade you they're not crazy. Or something they might say to keep you guessing.

When it comes to Mr. Market, it seems we're always left guessing whether he's being irrational or whether he's being shrewd when he moves a stock this way or that.

Wouldn't it be nice if we could figure out a way to tell the difference?

Well, that's the issue we'll be exploring as we look at the recently closed DG (Dollar General) short put trade.

DG - SUCCESSFUL TRADE - FINAL RESULTS

I actually closed this trade back on Thursday, 2017-07-27. Here's what I wrote in [the previous week's update post] covering the details:

This trade worked out exceptionally well with the shares running up into late July. I originally entered this position back on 2017-06-23 when the stock was trading @ $69.86.

Back on 2017-07-27, they broke above $75/share.

Since there wasn't a whole lot of time value remaining on the table, I went ahead and exited the trade when the stock was @ $74.87/share, buying back my August $70 short put for $0.35/contract.

After commissions, I booked $243.99 on $7K of cash-secured capital for a nice outsized 37.42% annualized ROI over 34 days (for perspective, the original terms projected through expiration was 26.49% annualized over 56 days).

THE MANY REASONS WHY THE DG TRADE WAS A GREAT IDEA IN THE FIRST PLACE

So here's the chart I put together for the Limited Downside Radar back on 2018-06-18:

P/E	15.84	EPS (ttm)	4.43	Insider Own	0.10%	Shs Outstand
Forward P/E	14.08	EPS next Y	4.98	Insider Trans	-2.26%	Shs Float

As a reminder, DG sold off big time on Friday, June 16th (along with a lot of other retail names) in the wake of Amazon's announced acquisition of Whole Foods.

Really?

It's hard to imagine finding customer bases farther apart from those of **Whole Foods** and **Dollar General**.

How does **Amazon** buying **Whole Foods** impact the dollar store business model one iota? Yes, I can understand the case for grocery store stocks like **Kroger** and **Sprouts** being under pressure, but dollar stores?

So **DG** tanking seemed like Mr. Market was being very irrational and simply overreacting.

But how could we know for sure?

Well, here's the deal - we don't just look for one data point or one reason to justify selling a put on a stock.

Remember, we want MULTIPLE reasons supporting the case for a near term limited downside in the shares.

And with this situation, we got them in spades:

- There was the knee-jerk sell off that didn't make sense already mentioned
- The stock was also trading at key technical support (see chart above)
- The valuation levels were also attractive
- The company was still expected to grow earnings (selling puts on an attractively valued stock that continues to grow earnings is always a nice safety net)
- I also mentioned in the Limited Downside Radar entry on **DG** that I preferred **DG** over rival **DLTR** which acquired Family Dollar a couple years back and, as a result, had a significantly higher debt load than **DG**
- **DG** also had an ex-dividend date scheduled for early July - while the dividend wasn't large, it still positively impacted the pricing of at/near the money puts (ala our Dividend Absorption approach)
- And premium levels were also very elevated thanks to the big sell off

Now, not all these factors tie in directly to the Limited Downside Situation thesis.

Some of the bullet points above just mean we get better pricing (such as the elevated premium levels and the upcoming ex-dividend date).

But that still has an impact on the safety of our trades because the more premium we collect upfront - providing we're not chasing premium and entering high risk trades in the first place - the more downside protection we give ourselves (i.e. lower breakeven/cost basis).

And another important point - the quality of the Limited Downside factors above is more important than their quantity.

Yes, finding "multiple" reasons why a stock is unlikely to trade lower, or lower by much, in the near term is important - but what's even more important is making the case with good reasons.

And as we've seen time and again, when we can find situations where the technicals, the valuation, and the fundamentals all come together, we usually have the basis for an excellent trade.

Additional factors are just icing on the cake.

When we get these solid, core Limited Downside reasons - and any additional "icing" reasons - then we have a good indication that, yes, Mr. Market is indeed being irrational.

And that should give us the courage and confidence and conviction to enter in and stay with trades where Mr. Market and his crowd of loud and blind followers are actively trying to persuade us that their irrational and unsustainable view of reality is the truth.

Eventually, Mr. Market wakes from his irrational fantasies - sometimes sooner as with the **DG** trade (37.42% annualized over 34 days) and sometimes later (such as our recently resolved **KORS** trade @ 10.89% annualized over 309 days).

FINAL RESULTS - TWO CHARTS

Finally, just to wrap this up, I thought I'd share the "before" and "after" charts on **DG** that show the story from a more visual perspective.

Again, here's the **Before Chart**, which I originally included in the Limited Downside Radar (and earlier in this case study):

P/E	15.84	EPS (ttm)	4.43	Insider Own	0.10%	Shs Outstand
Forward P/E	14.08	EPS next Y	4.98	Insider Trans	-2.26%	Shs Float

And here's the After Chart:

P/E	16.88	EPS (ttm)	4.43	Insider Own	0.10%	Shs Outstand
Forward P/E	14.98	EPS next Y	4.99	Insider Trans	0.00%	Shs Float