SELL RULES TO BUILD YOUR STOCK INVESTING PERFORMANCE

By William J. O'Neil

For many investors, selling is their greatest investment weakness. Remember that if your profits outweigh your losses, you are making progress. Spend time learning from your mistakes, and consistently use sell rules that keep the emotion and ego out of investing.

Even the most successful investors make mistakes. The key to investing is recognizing early on when you've made a questionable investment decision.

Well-known investor Bernard Baruch said, "Even being right three or four times out of 10 should yield a person a fortune if they have the sense to cut losses quickly."

When you make a mistake, admit it and move on—it is a simple rule, but one few investors are willing to follow consistently. If emotions and ego interfere with rule-based investing, these traits can become an investor's worst enemy and are the most difficult habits to erase. If you want to be a successful individual investor, you need to be as unemotional as possible in your response to the stock market. The biggest challenge is to acquire discipline and make your decisions fact-based.

Here are some proven sell guidelines I've used over the years very successfully. These sell rules are broken down into categories. Their combined strengths will become apparent to those who apply them consistently.

SELLING TO CUT LOSSES

The most critical rule every investor should follow is to cut losses. This is by far the soundest, most logical way to protect your portfolio against serious losses.

All stocks are speculative and involve risk. If a stock goes 7% or 8% below your purchase price, sell it. Sometimes after you sell to cut a loss, the stock will go back up in price. Were you really wrong if you sold your stock and it went back up? Were you also wrong for buying fire and car insurance when neither your house burned down nor you got into an accident? Think of the 7% to 8% sell rule as your small insurance policy against potentially devastating losses from which you can't easily recover.

If you have a worthwhile gain in a stock, you might ask if you should sell when the stock drops 7% from its peak. The 7% cutting losses rule does not apply in this situation. Once you have a profit in the stock, other rules come into play (discussed below under 'Selling to Take a Profit').

My philosophy is, "There are no good stocks … they're all bad … unless they go up in price." Make your losses smaller by recognizing this early on. Stocks should remain in your portfolio only as long as they perform well for you.

What about the "averaging down" strategy of buying more shares in a stock if the price drops? My advice is, don't do it—it is throwing good money after bad. The only averaging that makes sense is "averaging up" in your purchasing. Here's why: The most important factor in selling is buying at exactly the right time—not too early and not too late. Wait for the right time to buy, when a stock comes out of a sound chart base or price-consolidation period. If you begin buying at the correct buy point, the stock will rarely go

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7% or 8% below your purchase price. If you buy later when a stock is 10%, 20%, or 30% extended from a sound chart base, you will be shaken out on minor 8% pullbacks in price much more frequently.

SELL INDICATORS

Beyond the loss-cutting rule, watching a number of key fundamental variables in a stock will be your best ally. In general, those variables concern earnings, price action, industry or group action, profitability, and volume. This is really the "flip side" of buying, since these are the same variables you would examine when making a purchase decision.

You should consider selling any stock you hold that starts to show weakness in the following areas; you can find information that will help you track these variables in Investor's Business Daily's (IBD) SmartSelect™ Corporate Ratings, which compare each stock relative to all other stocks:

- *Earnings per Share*: A stock's earnings growth is the most important characteristic influencing a stock's price. Ideally, you should seek stocks showing current earnings increases of at least 20% over the same quarter's earnings one year prior and with past earnings of at least 25% annually for the last five years. Consider selling if a stock's earnings performance starts to falter, or if the earnings growth drops to only average relative to all other stocks (an IBD SmartSelect™ EPS rating of 70 or below, based on a relative scale of 1 to 99, with 99 the highest rating).
- *Relative Price Strength (price movement relative to other stocks)*: A stock's price should be outperforming (moving up faster than) 80% or more of other stocks. Consider selling if the relative strength starts to trend down, or has an IBD SmartSelect™ RS rating of lower than 70 (based on a relative scale of 1 to 99, with 99 the highest relative strength).
- *Industry Relative Strength*: Stocks also do well when they are in a leading or strong industry group. Avoid stocks in lagging industries (an IBD SmartSelect™ Industry Group Relative Strength rating of 'D' or 'E,' based on a scale of 'A' to 'E' with 'A' indicating the top 20%).
- *Profitability*: A company should show strong market potential for its products and services, as well as the ability to turn sales into profits. Look for strong and accelerating quarterly sales growth, high profit margins (net income divided by revenue) of 18% or more, and high returns on equity (net income after all expenses and taxes divided by stockholder's equity) of 17% or higher. You should consider selling if these measures fall below average (an IBD SmartSelect™ SMR—sales, margins, and ROE—rating below 'B,' based on a scale of 'A' to 'E').
- *Accumulation/Distribution*: Ideally, a stock should be experiencing moderate to heavy accumulation by the institutions. Consider selling if a stock has experienced moderate to heavy selling (called distribution) in the latest three-month period (an IBD SmartSelect™ Accumulation/Distribution rating of 'D' or 'E').

SELLING TO TAKE PROFITS

As you make better stock selections, your challenge will be to determine the best time to sell and take your profits. This one decision has paralyzed more investors than almost any other. It is not enough to be a good stockpicker. To maximize your profits, timing your sells when the stock has gone up is as important as your buys.

The best time to sell and take your profit is when your stock is advancing and still looks strong and positive to most investors. If you're able to time this type of sale correctly, you won't get caught in a drop or correction.

Here are some specific examples of when you may want to consider selling:

- The second time a stock splits in less than 12 months.
- A stock breaks up out of a base or runs up in price, yet the relative strength line does not break out into new highs, but lags substantially.
- There is a huge volume increase as a stock breaks below its 10-week moving average line.
- After months of significant price advance, a stock runs up faster than normal in just one or two weeks (usually 25% to 50%).
- Last two quarterly earnings reports show significant deceleration in their percent rate of increase.
- The majority of market leaders in the industry group have topped.
- The stock breaks up out of a base, but does so on less volume than the week before, or daily volume does not increase at least 40% or 50% on the first day or two of a breakout.
- After a long run-up for several months, the stock opens up on a price gap from the day before.
- The general market averages have clearly topped and several of the market leaders showed climax top action.
- Heavy volume increases are repeatedly shown as the stock drops.
- The fourth time a stock builds a base on the way up and breaks out to the upside (usually the price pattern will appear more wide and loose).
- Sell when you are all excited about all the money you're making and everyone is talking about what a great stock it is.
- Weed the flower patch—sell your weakest stocks first.

If several of these factors apply,

the case for selling becomes even more compelling. Figure 1 is an example of a stock that displayed several of these characteristics in late June.

THE MARKET

You can be right on your stock selections, but if you're wrong about the direction of the broad general market, you could have problems. Three out of four of your stocks will usually slump with the market averages, and you will lose money.

The key is to learn to read and interpret the general market indexes: Determine whether you are in a clear uptrend or downtrend in the overall market. And are you in the early or later stages? Is the market weak or acting poorly, or is it just moving through a normal decline? Look for confirmation or divergence in the three major indexes for clues.

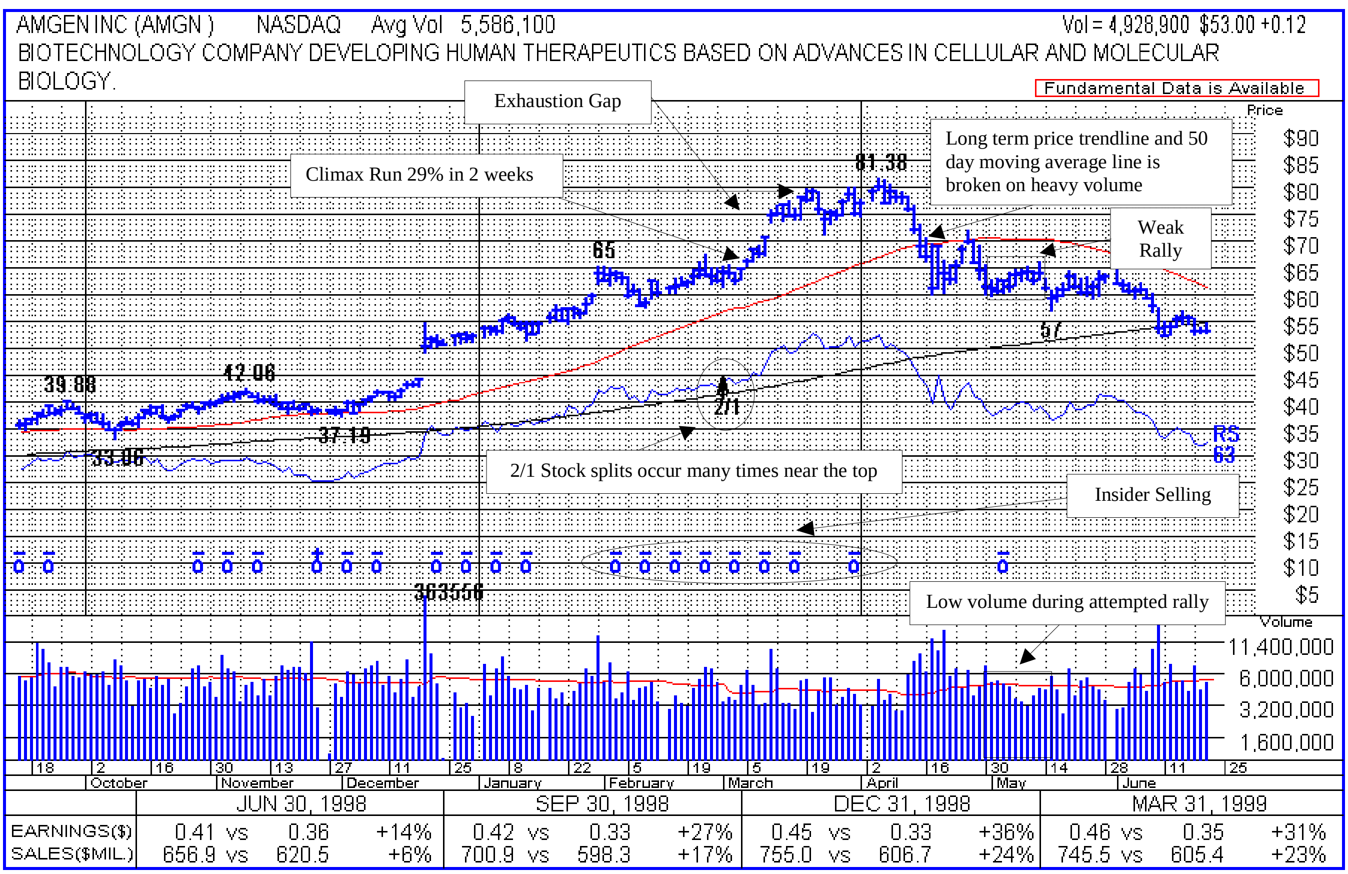
Market tops: I firmly believe that if you read the general market charts each day, you will, in time, learn to spot when the market is topping.

A market top always happens on the way up. You will encounter three, four or five days over a period of a few weeks where volume will increase from the day before, and the index price (Dow Jones, Nasdaq, or S&P) will either clearly close down from the prior day or stall and make very poor progress. These are "distribution" days, and after four or five days of this churning on increased volume with poor price progress, the market will usually turn down.

When you spot a definite top in the market, it is usually prudent to sell at least a few positions. You don't need to go to 100% cash, but lightening up your positions and getting off margin (if you use borrowed money) can be a sound decision in this instance. In other words, stop buying and reduce some positions to protect yourself from possible problems that might develop.

Attempted Rallies and Market Bottoms: At some point, the market averages will attempt to turn upward and rally. Don't get drawn into the first or second day of any attempted rallies—they could be false. Don't resume your buying until the market signals a clear and powerful follow-through. This usually occurs between the fourth and seventh day of most attempted rallies. A follow-through will have the market up for the day more than 1% and on higher volume than the

FIGURE 1. AN EXAMPLE OF SELL CHARACTERISTICS WHEN TAKING PROFITS



day before.

FINAL TIPS

Don't ever follow tips—other than this one—or rumors. Rely on proven rules and facts. Being disciplined enough to take advantage of the next market move is the real challenge.

In addition, it is essential that you review all your investment decisions to see where you went right or wrong. I can't emphasize enough how helpful post analyses of your sells—both the profitable ones and the losses—will be to improving your decision-making ability. My post analyses of my own failures in poor selling was the key turning point in learning to succeed in the stock market. You'll gain a stronger understanding of what you need to change if you plot on charts where you bought and sold all your stocks.

Knute Rockne once stated, "The way to succeed is to build up your weaknesses until they become your strengths."

I believe that for many people, selling is their greatest investing weakness. Once selling is mastered, you should be on the road to success. ◆

SELLING RULES: A SUMMARY

- Remember, no one is 100% right all the time. If your profits outweigh your losses, you are making progress. Spend time learning from your mistakes, and consistently use sell rules that keep the emotion and ego out of investing.

- Buying "right" will solve half of the selling questions. First, buy "right" on well-grounded fundamentals. Second, if you buy at the right time (pivot point) where a stock is showing the appropriate base structure, your stock will seldom drop 8% below purchase price. If you buy more than 5% to 10% past the pivot point, the price is extended … and you are probably too late.

- Always cut losses at 7%–8%.

- If you do not take a worthwhile profit when you have it, do not let a stock fall back below your purchase price. One should sell and avoid the loss.

- Do not let yourself get shaken out of a stock that has recently broken out and pulled back. The first time a stock pulls back to its 10-week moving average, it might be a buying opportunity.

- An initial 20% gain in only 1, 2, or 3 weeks should warrant holding a stock for a longer period of time since this may be an indication of real power and leadership.

- Big price advances take time, so be patient after a quality stock market leader has advanced. You may have to sit through the stock's first normal correction of 20% if you expect to capture a significant profit.