THE SELL DECISION: KNOWING WHEN TO WALK AWAY

By Albert J. Fredman

Impulsively jumping in and out of your fund holdings is not a sensible approach, but neither should you assume you can simply hold for a lifetime. Even for buy-and-hold investors, there are times when you will need to consider selling a fund.

Many people hop in and out of investments all too frequently. That's due in part to the fact that mutual fund advice and information are so freely available that individuals often are persuaded to switch from their more prosaic funds to those that have been delivering more exciting short-term returns. The widespread use of mutual fund supermarkets at discount brokerages makes a switch to a hot performer in a different family just a phone call away. However, impulsively jumping in and out of funds is not a sensible approach.

At the opposite extreme, others take the attitude that, once bought, mutual funds can practically be held for a lifetime. That can be true in some instances, but it's often not—you really must rethink your portfolio periodically. Investments that once were suitable may no longer fit with your objectives. There is also the possibility that a former top performer has become lazy. And some individuals make the mistake of buying bad or inappropriate funds or of misallocating their assets.

While it's generally best to avoid the extreme of holding forever, there are exceptions. For example, a good index fund could be a lifetime core holding because it likely will stick to its style and there is no danger of a star manager leaving.

Most mutual fund literature is concerned with the buy decision, which is certainly important. But knowing when to sell is at least as important.

This column analyzes legitimate reasons for selling funds, as well as several reasons for staying put.

LOUSY PERFORMANCE

Continuing poor performance of a fund relative to a relevant benchmark and its peers is the number one fund-related reason for selling a mutual fund. To do a complete analysis, you should focus on a fund's returns over the past one, three, and five years. Longer periods can be misleading if there have been major changes in the fund or its management.

While quarterly returns can be monitored to alert you to signs of deteriorating performance, one-year returns are the shortest relevant performance span for long-term investors to examine. However, that doesn't mean you should automatically sell if one-year returns turn up poor. Deciding how much time to give a poor performer to rebound is not easy, but you should seriously start to think about selling a fund that has lagged its benchmark and peers for the past 18 months to two years.

How do you decide on a relevant benchmark? That's not always easy either. Different benchmarks are available for different market segments and investment styles. For example, you can find indexes for small-cap growth, mid-cap blend, large-cap value, small Japanese companies, European stocks, or the total U.S. stock market.

A simple way to determine which benchmark to use is to check your fund's prospectus or annual report to find out what the fund compares its perfor-

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mance against. Unfortunately, there's really no good benchmark for multi-country foreign stock funds. International funds are commonly compared with Morgan Stanley Capital International's EAFE (Europe, Australia, Far East index), but this yardstick of 20 developed countries excludes companies based in North and South America and weights Japan heavily.

Another possibility is to compare your fund's performance with an index fund that has roughly the same portfolio composition. For instance, you might compare a broadly diversified domestic stock fund with the Vanguard Total Stock Market portfolio, which tracks the Wilshire 5000. However, you're never going to find a perfect benchmark because each fund has its own unique portfolio.

Keep the following points in mind when comparing a fund's performance with its benchmark:

- Mutual funds hold some cash, which will affect their returns relative to a fully invested index.
- Mutual funds incur expenses and trading costs, which will result in some underperformance relative to an index.
- Each fund holds its own blend of stocks and sectors, which will cause its returns to deviate from an index or benchmark.
- A mutual fund may be more or less risky than its benchmark.

Don't be too concerned if your fund trails its benchmark by a modest amount from time to time. In fact, the average growth or growth-and-income portfolio should lag the S&P 500 or any other market index due to its expenses and transaction costs.

Mutual funds provide important services that a market benchmark cannot. And a fund that trails its benchmark may be considerably less risky than another in its category that beats the yardstick. For that reason, it's often more revealing to see how a fund performed relative to its peers. You can compare a fund with several of its most similar competitors or with an average for the category.

It's always important to prune out any genuine duds. Some people tenaciously hang onto unproductive investments because they hate to admit that they made a mistake by purchasing one in the first place, or they may hate to deal with the tax consequences. The problem is that these individuals face a high opportunity cost by clinging to losing or mediocre funds.

OTHER REASONS TO SELL

Don't sell solely because your fund's performance has been disappointing during the past year. Rather, view a single year of underperformance as a signal to take a closer look at the fund and how it fits with your objectives. You should examine the following factors that may impact a fund's performance or its suitability for your portfolio.

- *A management change:* Management's ability is crucial for stock funds. But a management change by itself is not always a reason to sell. Perhaps the manager who left was not exceptional. A good replacement for a skilled manager may be waiting in the wings at a large fund company. Conversely, if a star manager leaves a fund run by a tiny complex, a good replacement may not exist. Finally, think seriously about selling if a fund has had more than its share of management turnover, because frequent changes are not healthy.
- *Rising expenses:* Significantly higher expenses can hurt performance. Perhaps a 12b-1 fee has been added or management fees have increased. A money market fund may have lifted a fee waiver, causing its yield to drop significantly relative to other similar money market funds. An increase in costs is particularly hard on bond and money market funds because they earn lower gross returns than stock funds.
- *A surge in assets:* Performance could falter if a small-stock or micro-cap fund is flooded with investor money. And the fund could experience style drift if it is forced to start investing in bigger companies. Conversely, a surge in assets may be no problem for many other types of funds, particularly for high-grade bond and money market funds that could benefit from economies of scale.
- *Shrinking assets:* Watch out if a fund is rapidly losing assets because investors are jumping ship for some reason. Sizable redemptions can force management to dump good stocks to raise cash. If gains are realized, the fund could make an unusually high capital gains distribution, saddling those who hold shares in taxable accounts with a potentially large tax bill.
- *A strategy change:* Funds change strategies in various ways. A new portfolio manager might decide to fully hedge currency risk for a foreign stock fund that previously did not hedge. An active trader might take the helm of a fund that was noted for low turnover. Or a small-cap value fund might become a mid-cap growth fund. A strategy change will not necessarily hurt a fund's performance, but it might not help a laggard either. If the new strategy does not mesh with your objectives, it may be time to move on.

Even if your funds have compared favorably to their benchmarks and peers, there can be other, compelling reasons to sell. Conversely, you may not want to walk away from a laggard just yet. That's because personal factors often dominate in the decision-making process.

TAX CONSIDERATIONS

If selling seems warranted by the performance numbers and other factors, you also need to weigh any

potential tax liability you would incur by taking a large gain. On the plus side, the tax consequences may be less painful now with long-term capital gains taxed at a 20% maximum. In addition, the long-term capital gains holding period was recently shortened to more than 12 months from more than 18 months. Nevertheless, if you would be in for a hefty tax bill it may make sense to give a lazy performer more time. This obviously is not a concern if your fund is held in an individual retirement account or other tax-advantaged plan.

On the other hand, tax considerations may argue for a sale. Do you have a paper loss in a taxable account? Perhaps you hold a fund that has done poorly because it invests in a stock-market sector, country, or region that has experienced major problems. You might expect an eventual rebound, but in the meantime you could lock in your loss to offset other gains, thereby reducing your tax bill. Short-term losses are especially advantageous when they offset short-term capital gains, which can be taxed at federal rates ranging up to 39.6%. In addition, up to $3,000 per year of net capital losses can offset ordinary taxable income under laws in effect at this writing. The unused portion of an excessive loss can be carried forward to offset future income and realized gains.

If you are sitting on a large loss yet still feel your fund is a good long-term holding, you could sell the shares and buy them back later. But be aware of the so-called wash-sale rule. Technically, a wash sale occurs if a security is repurchased within 31 days after it is sold, thereby "washing out" any right you might have had to deduct the loss. This rule also prohibits you from buying shares within the 30 calendar days prior to your tax-loss sale. In total, it covers a 61-day period, with the date of sale occurring at the midpoint. Of course, your fund's net asset value could rise while you're waiting to buy back the shares. To avoid a wash sale, you could invest immediately in another fund with a similar objective.

DUMPING EXCESS BAGGAGE

Individuals who own too many funds might consider paring their holdings down to a manageable number, perhaps to as few as five or six. Money-losing investments should be pruned along with unsuitable ones. Your performance likely will improve, and your financial life will be a lot simpler. Plus, it will be much easier to track your asset allocation.

People often make purchases that they regret later. These could include a socially conscious fund, a gold fund, an S&P 500 index fund with a high expense ratio, a narrowly focused fund that makes you uncomfortable, or any gimmicky fund. A broad-based asset allocation fund is unnecessary if you've allocated your assets properly in the first place. Or perhaps you've recently learned about the virtues of indexing and want to replace a sluggish large-cap growth and income fund with an S&P 500 index fund.

Suppose you hold a fund invested in an asset class that has done poorly even though the manager has fared better than the benchmark. For example, between mid-1997 and mid-1998, some Asian markets plunged from 60% to 90% in U.S. dollar terms. Individuals who tenaciously held big positions in Asian single-country and regional funds during the past year or so know how it feels to lose big time. The Japanese market has performed abysmally much of the time since 1990, and most of the Asian tigers have experienced horrific declines since mid-1997 due to plunging currencies and stock markets. In these cases, you need to decide whether you still want that asset class. This is often a difficult call. It depends on factors such as your age, time horizon, and investment outlook.

Generally mutual funds are viewed as safe because you won't lose as much as you could with an individual stock. But narrowly focused funds can be dicey. If you have allocated too much to a focused fund that's on the skids, think about reducing or eliminating that position before the loss becomes unmanageable. If a volatile fund plunges 50%, it must rebound 100% just to recoup its loss. At recent levels of about 14,000 on the Nikkei, the Japanese market must rebound nearly 180% to get back to its extremely overvalued peak of 39,000 in 1989! Consider selling when a speculative fund has fallen 15% to 20% below your cost. Even if you have a relatively minor position, you still may want to walk away. It's not always wise to stick around to see just how long it takes a sick market or sector to bottom out and recover, especially if you can use the tax loss to offset other gains.

PORTFOLIO RISK CREEP

Other reasons to sell may arise in your periodic asset allocation review, which should be done at least annually. This entails checking your allocations to big-cap stocks, small-cap stocks, foreign equities, bonds, money market funds, and any subcategories. If you are overweighted in certain stock areas, it may make sense to prune your holdings back to your long-run target allocation. By doing this, you avoid so-called "risk creep": the tendency for one or more of the most volatile asset classes in your portfolio to become overweighted. This is particularly a problem in aging bull markets, when investors often become too complacent. Portfolio rebalancing contains a built-in buy-low, sell-high mechanism.

Recognize that your stock funds could plunge anywhere from 20% to more than 40% within a few months during a bear market.

Investors experienced such declines during the September to November 1987 tumble and the August to October 1990 slide. At this writing (mid-September), sizable declines have occurred since the Dow Jones industrial average peaked at its July 17 closing high of 9337.97. You might want to check and see how your funds and similar ones did during these periods to get a feel for what could happen during a bear market. If you feel uncomfortable with a decline of that magnitude you should rethink your asset allocation.

However, if selling would result in large capital gains, you may wish to consider the following alternatives.

- Sell stock funds held in tax-deferred retirement plans to restore your balance.
- Make a more gradual change in your asset allocation by investing any new money in the underweighted categories or reinvesting distributions from your overweighted funds into your underweighted holdings. This second alternative is particularly desirable if you feel there is a good chance your overweighted funds will continue to advance and you wish to make a more modest reallocation for the time being.

STAYING THE COURSE

It's generally unwise to make a big shift from stocks to cash because you fear a bear market. Trimming your stock allocation back a moderate amount—say, from 80% to 65% of your assets—can make sense in a pricey market, but drastically reducing it because you fear a plunge is basically market timing. The stock market will fluctuate, but you can't pinpoint when it will tumble or shoot up. If you have allocated your assets properly and have sufficient emergency money, you shouldn't need to worry. Naturally, you want to make gradual reallocations to avoid risk creep, as discussed above.

Table 1 illustrates that missing out on a few big up months can make a sizable difference in your long-run results. These data are from a study conducted by Lipper Analytical Services covering the 240-month period from December 1977 through December 1997. If you bought and held the S&P 500, you would have earned 16.65% compounded annually over the entire 240 months. The more exceptional months you missed, the worse the outcome. Your annualized return drops nearly five percentage points to 11.66% if you missed the 10 best months! Thus, market timers risk being in cash at the wrong time. People who abandoned stocks at the beginning of 1995, 1996, or 1997 know this all too well; the S&P 500 returned roughly 30% annually on average during this unprecedented three-year stretch. Market timing is particularly unwise with a retirement nest egg that won't be tapped for many, many years.

Finally, don't panic and sell just after a big plunge. You could lock in a loss and miss any rebound. Panic-selling rarely makes sense because investors tend to overreact to recent bad news, hammering prices to unrealistic lows. The market recovered and went on to far higher ground after the 1987 and 1990 bear markets, which were fairly short-lived by historical standards. But even if the bear market is longer and more painful, as in 1973–1974, it's important to remember that stocks have a bullish bias and gain a lot more in the bullish phases than they lose on the downside—that's why the long-term trend of the market is up.

Of course, this assumes you have sufficient liquid assets in money market and short-term bond funds to meet emergencies and planned big-ticket expenditures over the next several years. Recent market conditions underscore the importance of maintaining enough liquidity at all times. The following is a good rule to keep in mind: Don't have money invested in stock funds that you will need within the next five years. By following the five-year rule, you greatly reduce the risk of having to sell shares after a market tumble.

A CHECKLIST

Table 2 provides a checklist to help you determine whether to sell or hold a fund. The 10 fund-specific and personal reasons for selling or holding are often interrelated and must be carefully weighed. When you have finished your evaluation, one of the factors will typically predominate as a key reason for selling or holding. Questions 9 and 10 obviously come into play only when your fund is held in a taxable account. Thus, the selling decision is simpler for those funds held in tax-favored retirement accounts.

Review each of your funds annually and after major changes in your personal circumstances, using these questions as a focal point. It

TABLE 1. THE RISK OF MISSING THE BEST UP MONTHS: 1977 TO 1997

Time in Market	Return* (%)
Entire 240 months	16.65
Less the best month in the market	16.00
Less the 3 best individual months in the market	14.75
Less the 5 best individual months in the market	13.66
Less the 10 best individual months in the market	11.66

**Compound annual results based on S&P 500 returns from December 1977 to December 1997.*

Source: Lipper Analytical Services, Inc.

may be helpful to answer the questions in writing and keep the evaluation with your records on each fund you decide to hold. This will facilitate the analysis when you go back to review the funds on your "watch list."

GETTING INFORMATION

Mutual fund research publications such as *The Individual Investor's Guide to Low-Load Mutual Funds*, Morningstar Mutual Funds, and The Value Line Mutual Fund Survey are useful for monitoring a fund's performance and other characteristics. Performance data also are available in The Wall Street Journal (on Fridays), Barron's, the AAII's *Quarterly Low-Load Mutual Fund Update*, and other periodicals. You also can call your fund company or visit its Web site for recent information.

The Web site FundAlarm (www.fundalarm.com) analyzes more than 2,000 stock and balanced funds and provides sell indicators on those funds. Updated monthly, FundAlarm also offers useful news and commentary about individual funds and the fund industry, a monitored bulletin board, and links to other Web sites. The site is run by Roy Weitz, who offers his analysis at no charge to interested investors. He does this as a hobby and also has a full-time job as a money manager, as he explains in the personal background section on his Web site.

The most important factor considered by Weitz is a fund's past performance relative to an appropriate benchmark. FundAlarm uses index funds such as the Vanguard Index 500 and Schwab International Index Fund as benchmarks. However, his benchmarks may not always match the fund's asset class that precisely. Weitz advises taking a close look at his group of 3-Alarm funds. These funds have underperformed their benchmarks for the past one, three, and five years. Also examined are management tenure, a fund's performance relative to its peers, its riskiness, median market capitalization, and changes in net assets. FundAlarm can offer a useful second opinion if you are thinking about selling a fund that is included in its database.

CLOSED-END FUNDS

All of the factors identified in Table 2 are relevant when you are contemplating selling a closed-end fund (except question 4 because closed-end managers work with a stable pool of capital). However, you face other considerations as well because closed-end funds are similar to stocks. Suppose you bought a promising closed-end fund at a deep discount. You made a good choice, the fund performs well, and the discount narrows significantly or turns to a premium. This is a sell signal because discounts and premiums are "mean reverting" and the following scenarios are often likely:

- Abnormally deep discounts eventually narrow;
- Abnormally small discounts deepen; and,
- Excessively high premiums deflate.

TABLE 2. THE SELL DECISION: A CHECKLIST

Fund-Specific Questions

1. *How has my fund performed relative to an appropriate benchmark and its peers over the past one, three, and five years?* The more serious the underperformance, the greater the incentive to sell. Alternatively, if the underperformance has not been too serious but has been getting worse recently, consider questions 2, 3, 4, 5, and 6.
2. *Has there been a change in management?* If so, when? This is not always a problem, but be concerned if a star manager leaves or there has been high management turnover.
3. *Have expenses risen significantly?* Higher expenses reduce returns, particularly for bond and money market funds.
4. *Have assets increased or decreased substantially?* A surge in assets could have an unfavorable impact on the performance of a small-stock fund if it becomes too large to function effectively. Conversely, ongoing redemptions spell trouble for any fund.
5. *Has there been a strategy change?* This may or may not be a problem, but consider selling if a fund adopts a new strategy that does not fit with your objectives.

Personal Questions

6. *Given my personal situation and knowledge of this fund today, would I buy it?* Inappropriate funds should be sold. For example, eliminate an asset class that's no longer suitable for your portfolio.
7. *Do I own too many funds?* Sell less desirable holdings in a cluttered portfolio to simplify your task going forward. Applying questions 1 through 6 to each fund will help you decide which ones to weed out.
8. *Do I need to rebalance my portfolio?* To eliminate risk creep, pare back exposure to one or more asset classes that have become overweighted in an aging bull market.
9. *Would selling result in a substantial taxable gain?* Selling can be a tough call in this case and requires further analysis (particularly of questions 1, 6, and 8) before jumping ship.
10. *Could I realize a significant loss that would offset gains and reduce my tax bill?* This is a good reason to sell. If you still want exposure to the asset class, you could switch immediately to a similar fund or buy the same one back after waiting more than 31 days to avoid the wash-sale rule.

Selling is particularly important if the fund goes to a steep premium, which is like a high price-earnings ratio on an overvalued stock. Your paper profits can quickly deflate as the premium regresses to the mean.

Occasionally, a closed-end fund will convert to an ordinary mutual fund; nine did in 1997. This often happens when a group of so-called "fund busters" acquires a large position in a fund trading at a deep discount and solicits the cooperation of other shareholders in trying to persuade management to open-end. If the fund becomes open-ended, its discount will disappear and shares can be redeemed at net asset value.

Consider selling when open-ending has been approved. Most of the narrowing of the discount occurs between the announcement of a strong open-ending proposal and the date the conversion is approved, according to a Morgan Stanley Dean Witter study. The remaining convergence then occurs over a four- to eight-month period. Investors who remain in a closed-end fund after conversion often are worse off because:

- Large redemptions by exiting shareholders force management to dump shares and realize and distribute huge capital gains.
- Expense ratios rise with shrinking assets.
- Performance suffers because the fund no longer has a stable pool of capital.
- Funds typically charge redemption fees of 2% or so after conversion.

Finally, be sure you get the best possible price when you sell a closed-end fund. If you try to sell in a hurry by offering your shares at the bid price you could easily force your fund's price down. It's often wise to place an open limit order to sell at the asked price. You could receive a higher price by being patient, and you are less likely to force the price down in the process of selling, particularly if your order is large.

SHOULD YOU WALK AWAY?

The sell decision is often more difficult than the initial decision to buy. It is complicated because several factors are involved, including emotions, fund performance, asset allocation, and taxes. Reevaluate your holdings at least annually to make sure they still mesh with your objectives and offer good potential. The checklist in Table 2 will help focus your analysis of your funds.

Many people buy and sell too often, however. You could wind up making two mistakes: selling a fund you should have kept and buying one that was best left alone. By always buying carefully and sticking with a well-conceived, long-term investment plan, you are less likely to be swayed by short-term market developments. Yet you need to remain flexible enough to modify your asset allocation if your personal situation changes. ✦