WHEN TO SELL A STOCK: PRACTICAL AND PROFITABLE RULES

By Donald Cassidy

Many investors feel the odds are against them if they sell. Reinforcing that perception is the mutual funds industry, which constantly drums the "buy and hold," refrain, often translated into "buy and never sell." That is ironic because growth funds have holding periods of slightly under a year.

Selling is the hardest part of investing. Yet it must be done. If you cannot sell, your current portfolio will become your heirs' problem. Predetermined long-term holding implies average return performance, since markets rise and fall, and companies' fortunes change over time. While fundamentals undeniably drive stock values in the long term, psychology sets prices in the mean time.

Because market psychology works on us all as investors, you must specifically work on learning to sell well, or you will predictably do it badly.

This article is designed to help you understand selling and give you some practical rules for doing it well.

To arrive at a successful approach in sports, the coach or individual competitor must understand the playing field and the competition. In investing, success requires an understanding of the factors governing the landscape. So, in order to understand how to sell well, you must first recognize and understand the important influences that pose obstacles. These are of two sorts: external and between-our-ears in nature.

EXTERNAL FACTORS

External factors that inhibit stock selling are numerous and powerful, and they supply a systematic bias toward holding.

First, our culture is one of optimism, and most investors tend to be well-off, experiencing progress over time. Therefore selling, which is an act of closing off or ending, appears an unnatural thing to do, probably one that will inhibit rather than enhance gain. Besides, well-known evidence shows that stocks provide about an 11% average annual return over the long term, and the major averages rise about seven years in 10. Thus, we feel the odds are against us if we sell.

Reinforcing that perception, the mutual funds industry has drummed constantly on the refrain "buy and hold," which of course means "buy and never sell." That is ironic because growth funds have holding periods of slightly under a year—the latest data from Lipper Inc. shows that the average turnover ratio for stock funds last year was 115%.

Tax-bogeyman media stories abound, castigating mutual funds that are tax-inefficient for not holding all stocks interminably.

Likewise, brokerage ads counsel long-term holding, thus striking a tone of prudence and responsibility. Brokers who practice frequent selling are branded churners.

The unspoken assumption behind the hold-forever mantra is that you own the right stuff and it will forever remain such. Until the spring of 2000, the consistent reinforcement of an 18-year bull market with only temporarily mild interruptions was a constant reminder that any sale would probably be a mistake. And on a personal level we each know of someone who mistakenly sold a supergrowth stock years ago and missed a tenfold or greater gain.

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In addition, traders are viewed as gross speculators, and thus bad investors; therefore selling itself, which they do frequently, is viewed as an evil. Patience, after all, is reputedly a virtue.

Finally, most investors know that when one stock is sold, you must find a replacement purchase, and that takes study time and raises predictable decision-making stress, which is sidestepped when a stock is simply held.

EMOTIONAL BAGGAGE

If those outside influences aren't enough, personal psychology—the baggage everyone brings to Wall Street—can also get in the way. For starters, our egos get in the way of successful investment results. Our culture equates self worth with money and in investing, money comes from being right. Investors wish to be not merely right, but perfectly right. However, most people also know that they will not sell at the all-time (or even the week's) high, so they avoid exposing their egos to self-imposed feelings of inadequacy by not taking any action. Holding winners forever leaves them always present to stroke the ego. Selling a stock that has done well evokes the pain of parting with a beloved pet or favorite collection, while selling a loser admits defeat and an intellectual shortcoming. Why abuse the ego when it's not necessary? The sense of power is also enhanced when options are retained (hold to see what happens). Refusing to sell also lets us avoid distasteful costs—commissions and especially taxes.

GOING WITH THE FLOW

At a practical everyday level, events—including general-market and specific-stock price movements—are so vivid that they trigger us to make wrong moves, selling in panic in one direction and buying with the crowd as if there were no tomorrow in the other.

Financial TV and the Internet provide highly mixed blessings: Vast amounts of information have become free and immediately available, but we tend to over-react to this plethora of stimuli. Friends and acquaintances unintentionally but systematically act to thwart any contrarian intentions: Tell them you are selling an overpriced market favorite or refusing to sell during a market panic attack, and they will unleash a firestorm of "reasons" the crowd believes you are wrong.

WARNED AND ARMED

While you cannot change the world you face, if you recognize and understand the enemies of profitable selling you have a better chance of overcoming them.

It cannot be emphasized too strongly that selling must become a routine act—as normal in your own mind as buying. Because of how emotions like fear and greed operate in the Internet age, you must become a nimble and proactive seller. Investors get paid much more to anticipate changes than to react to something that has been publicly reported.

Here are some selling rules that will help you overcome some of the hurdles to making intelligent sell decisions. I sort these into three types: big-picture guidance, general good practices, and short-term tactics.

BIG-PICTURE SELLING RULES

1.) Use the 'rule of 110': Subtract your age from 110 to determine the proper percentage of assets you should have in stocks and equity funds to bring some discipline to your asset allocation. A pre-determined allocation forces you to sell at propitious times when stocks are high and keeps you from selling out in low markets.

2.) Never hold what you would not buy again at today's price. You should view holding as buying "again" for tomorrow. What you would not buy you ought to sell, since holding it depends on greater fools to support its price!

3.) When the market averages have risen 20% to 25% in 12 months, sell something to lower your capital risk; the higher your age, the lower your trigger should be—remember your proper asset allocation level (see Rule 1).

4.) Do some selling when popular magazines, front-page headlines in non-financial papers, and TV and cartoon humor celebrate bull-market conquests. Those things happen only late in advances.

5.) When you feel really smart and absolutely love a stock and your own brilliance, sell. This never happens in cheap markets.

6.) Sell when technology or competition commoditizes a company's product. Long-distance phone companies two years ago are a classic example.

7.) Sell a stock when other companies in its industry report bad news other than management fraud.

8.) Periodically sell part of your position in any perfect-performing company ("never" reports disappointing earnings). This cuts your capital risk since such stocks are disasters waiting to happen. Those 40% overnight price smashes *can* happen to you.

9.) Do some selling every time the general market is up for three years running. Then historical odds are starting to be stacked in favor of a significant downturn, and your biggest winners will decline the most.

10.) Believe in, and practice, what is implied by 'cockroach theory': the first piece of bad news you see is unlikely to be the only one. Stocks widely held by institutions will be

hammered because those holders have no patience with lost momentum.

11.) Do not sell a stock because and when the general market is scaring you. That state of mind develops only very late in declines, so at that point holding on is a better bet.

12.) Get over 'tax phobia'! Short of dying (a clever but extreme IRS-dodging gambit) you must pay taxes to take profits. The object of the whole pursuit is to take profits. Otherwise you must perfectly choose stocks so you can hold them for life. No one is able to do that, since companies are not guaranteed perpetual winners. Reduced long-term capital gains tax rates are a happy bonus, not an entitlement. Do you refuse your paycheck because earned income is taxed at the full rate?

13.) Never sell one stock simply to raise money to buy another. Instead, sell on merit. Selling to buy reflects excessive (too-urgent) bullishness that occurs only when a stock (seemingly so compelling), and the general market, is overbought and ready for a fall.

GENERAL GOOD PRACTICES

14.) Spend equal time thinking about which holdings to sell and which new candidates to buy.

15.) If thinking about paying commissions keeps you from selling, ask yourself whether you worried about the commission when you were buying.

16.) Unless a big winner is within weeks of becoming a 12-month (long-term) holding, never use taxes (or commissions) as a reason for not selling. Those are rationalizations for wanting to avoid the stress of making a sell/hold decision. That stress will always be there, so deal with it!

17.) Never stubbornly hold on to a stock that has dropped just to make your original investment back. We all make buying mistakes; insisting on 100% price repair will leave you holding laggards when other stocks are doing much better. Accept your human fallibility and get on with your investment life. Always think about opportunity costs. Refusing to accept a loss is part of irrational perfectionist standards we set for ourselves.

18.) Sell based on a scenario you expect to work out and within a given timeframe. If you have no expected price based on concrete reasons (even though your logic will never prove perfect), your money is already doomed to float aimlessly.

19.) Set a target price that you enter immediately upon purchase. That puts a discipline in place and keeps you from raising your target when the good news you expected comes to fruition.

20.) Sell when your stock moves well above the target path from buy to intended sell price. Crowd enthusiasm literally cannot last, so abnormal price bursts are unsustainable. Gracefully collect your winnings and look to buy back later at a more reasonable price. The experience of selling well will enable you to make future selling decisions more easily.

21.) Do not sell because stock-price action scares you, unless that price decline is driven by truly important bad corporate news. This is a stock-specific rule parallel to Rule 11 regarding the overall market.

22.) If you own a very popular stock, or one that is widely held by institutions, sell it two days before quarterly earnings are to be reported. Positive surprises are given tiny and fleeting price rewards, but negative surprises are brutally and lastingly punished. Stepping aside literally takes you out of having the risk/reward odds stacked heavily against you. Discount-broker round-trip commissions are extremely cheap insurance. Dates of earnings per share announcements are available on the Internet at Yahoo! Finance (finance.yahoo.com) in the Earnings section under "Today's Markets." Routinely selling and paying taxes on your gains prevents you from ever feeling locked in by big tax liabilities on long-held winners.

23.) Ignore three prices of which you are keenly aware: the highest price a stock ever reached, its best level since you've owned it, and your cost basis. These are all irrelevant to the market and to future prospects and values. These prices are false private benchmarks.

24.) Immediately sell any utility stock or REIT (real estate investment trust) that does not raise its dividend every 12 months like clockwork by at least an amount equal to its last increase. Directors' changes in policy telegraph bad news coming, and you should not wait for the details. Own only stocks in groups that are growing dividends, since they are the healthy ones.

SHORT-TERM TACTICS

25.) Set intelligently placed stop-loss orders, which impose anti-rationalizing discipline. Never use stop-limits, since they let a rapidly declining market pass your order by. Arbitrary percentage-down prices related to your original cost are irrelevant to the market. Technical break-down points based on chart analysis are much better. If you do not understand technical analysis, that ought to be your next study project. It is driven by market psychology, which causes price change.

26.) If you have a paper loss but refuse to sell because you "think it will come back," impose this test:

Sell the stock and replace it with a related exchange-traded fund. If you are not confident enough to make that purchase, then it is clear that you are basing your outlook on simply hope rather than concrete expectations. Hope is major a sign of troubled thinking in investing or trading. You should sell if your outlook is based solely on hope.

27.) Early each November (to beat the crowd), sell stocks with losses. Match those losses by taking equal total profits in winners.

28.) When the market rises six days in a row (which it does only once or twice a year), sell at least one currently strong stock and buy it back later. Odds of a correction are high.

29.) On the second day a stock has risen strongly in response to a major brokerage firm's buy advice or upgrading, sell the stock. That buying is from a temporary crowd that will soon wane. You will be able to buy the stock back very soon several points lower. Again, the practice of selling skillfully will do well for you.

30.) When huge good news causes a stock to gap higher, sell between 11 a.m. and noon (Eastern time) that very day! News is now known immediately worldwide; therefore, the entire crowd that might rush to buy on good news has done so much sooner than would have been the case in years past. Sell into their foolish haste to buy at any price. When the crowd is satisfied, the stock literally cannot stay up. You can buy back later and pocket the substantial cash difference.

31.) If you are unfortunate enough to be caught with a stock that gaps down on bad news, realize that the institutions are not yet done exiting, so the stock will languish at best for an extended period. If you find selling appropriate, wait until somewhere between the third and fifth day, when a moderate rally usually occurs as urgent selling abates. Typically this tactic will net you a better price than selling during the rush of the first day.

SUMMARY

The preceding observations and advice unabashedly depart from the buy-and-hold faith. In my experience, they are more easily accomplished than finding the needle-in-a-haystack stock that will rise as long as you live—let alone a diversified portfolio of such rarities.

This approach to proactive selling provides above-average return by protecting capital and capturing excess returns when available.

Quite likely these rules would have spared you loss and pain in the bear market that began in March 2000. They certainly did that for me. ❖