Success in the stock market is as much about limiting losses as it is about riding winning stocks.

A rule-based selling strategy can help you avoid heavy losses and preserve your portfolio. This article explains how to sell when a stock selection doesn’t pan out.

Know When to Fold ‘Em

Nobody’s right all the time in the market, not even veteran market professionals. But as the famous investor Bernard Baruch once 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.”

Being a successful investor is just as much about limiting losses as it is about riding a winning stock. Downturns are a part of life in the market, and you must act decisively to shield yourself from excessive losses. If your stock selection doesn’t work out and you’re faced with a loss, don’t let your pride stop you from admitting you’ve made a mistake and acting quickly. Cut your losses early and move on. You must make rational decisions, instead of trying to rationalize your way out of a costly mistake.

Cut Your Losses Early

My primary rule is to sell any stock that falls 8% below your purchase price.

Why 8%?

Research shows stocks showing all the right fundamental and technical factors in place and bought at the proper buy point rarely will retreat 8%. If they do, there’s something wrong with them. You may think a stock is due to rebound. But the market could send the stock to lower depths regardless of your views or what analysts and commentators say on TV. No excuses, no alibis. You may want to sell even before an 8% loss if you see other signs of weakness in a stock.

This sell rule emphasizes the importance of buying at the right time. If you don’t and you buy a stock that is overextended (in other words, it is reaching the end of its climb), chances are it will hit the 8% sell level as it goes through a normal pullback. Make no exceptions to the timing of your purchase. The best stocks will always give you other opportunities to buy.

Here’s another way to look at it: Once a stock falls 8% below your cost, does it still look attractive? Is it still among the best stocks? Probably not. There’s no guarantee that it will go back up, and you need to protect yourself.

The bigger the fall, the harder it is to recover. Say you bought a stock at $100 a share, and it falls 20% to $80. To
get back to $100, the stock has to make a 25% gain.

Another example: The stock plummets 50%, to $50 a share. It would take a 100% jump to get it back to $100—how often do you buy a stock that doubles? And if it does, how many weeks, months or even years does it take to get there?

In short, it is much easier for your portfolio to recover from an 8% drop than from a 50% drop. Wouldn't you rather cut your loss early, and free up money to purchase another stock with better chances of doubling?

Of course, it could happen that you sell a stock that falls 8%, and then watch it go up afterward. But you have to think of the 8% sell rule as your insurance policy against catastrophic losses. The rule will in effect limit any losses on your portfolio to no worse than 8%.

**How It Helps**

Table 1 shows two sets of hypothetical trades that illustrates how cutting losses can help your overall portfolio.

Both portfolios start out with an equal dollar amount invested in five stocks, for a total of $25,000 invested; both portfolios invest in the same stocks, but the second portfolio’s two winning stocks have more gains.

As you can see, in each portfolio, if you had made these five trades over a period of time—and taken losses on three of them—you would still either break even if you had modest gains in your profitable two stocks (Portfolio 1) or you would come out ahead by $1,800 with solid gains in the profitable stocks (Portfolio 2). That’s because the two stocks that worked out resulted in a combined profit of $1,200 in Portfolio 1, and $3,000 in Portfolio 2, while the three losses—all capped at 8%—added up to $1,200.

The point is, it takes several 8% losses to wipe out the profit from one or two good stocks.

**Rule Applies to Purchase Price**

The 8% sell rule applies only to drops below your purchase price and does not apply to situations where you’ve already made worthwhile gains on a stock.

If you are a stock investor, you must learn to weather temporary sell-offs that may be 8%, 10% or even larger.

How can you tell the difference between one such dip and a real problem?

**Hyperactive Stocks**

About 40% of stocks pull back close to their buy point for one or two days. This is not the time to panic and sell if you have timed the purchase properly as it came out of a sound basing area. In other words, by timing your purchase right—at an already established floor—your sell rule should not interfere with the normal pullbacks that typically occur. As long as the price doesn’t drop 8% below the point at which you bought it, you should, in most cases, hang on through the first pullback.

Watch how the stock performs relative to the general market and its industry group peers. Often, a stock pulls back close to the buy point for one or two days because the general market has temporarily pulled back. This is normal.

On the other hand, if the market has been rallying over several days and your stock hasn’t come to life, then this might be a warning sign, even if the stock hasn’t dropped 8% below your purchase price.

Another point to consider: Stocks that are doing well relative to the market (with high relative strength) are usually more volatile, increasing the chance of slipping 8%, particularly if you buy them extended in price beyond the exact buy point.

**Other Protections**

One way some investors implement the 8% rule is through stop-loss orders, which are instructions to brokers to sell a stock at a predetermined price.

This might be useful for those who can’t watch their stocks closely or for those who may be less decisive and want a strictly mechanical approach.

In addition, don’t let tax considerations and brokers’ commissions interfere too much with your sell decisions. For instance, some investors are afraid to take gains because of the taxes and commissions. You shouldn’t always hold a stock...
for more than a year just because you’d pay a lower tax rate on the profit, and with lower commissions today, brokerage fees should not be the most important factor. Your main goal should be to obtain and nail down gains and cut losses.

Losers in Your Portfolio

You may now look at your portfolio and see that there are some stocks already 8% below your purchase price—or worse.

Should you sell them?

Probably, unless a stock is showing strong signs of recovery, such as a rising stock price on solid trading volume and improving earnings. Even then, there is no guarantee it will rebound, and the chances are it could go even lower.

The greater the loss, the greater the chance of it developing into a really serious loss.

Key Points to Remember

Here are the main points you should keep in mind when trying to protect your portfolio against losses:

• The first sell rule is to get rid of any stock that falls 8% below your purchase price.
• It's critical to follow this loss-cutting rule regardless of how highly you value a stock. Personal opinions get in the way of smart selling decisions.
• The larger the loss, the higher the recovery you need to get back to the break-even level. (A 50% loss on a $100 stock, for example, requires a 100% gain to get back to $100.)
• Strong stocks sometimes initially retreat close to their buy point (as determined by the stock’s chart pattern). This doesn’t necessarily mean you have to sell—unless the stock goes 8% below the purchase price.
• Avoid making sell decisions based solely on tax concerns or commission rates.

William J. O’Neil is founder of Investor’s Business Daily, the only national daily newspaper that focuses exclusively on the investment markets using proprietary, data-based screens and ratings. He is also founder of William O’Neil + Co., a leading institutional investment research organization based in Los Angeles. Mr. O’Neil is also author of “The Successful Investor,” $10.95, published by McGraw-Hill.

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