

40th Anniversary

FROM THE ARCHIVES

The Sell Decision With Mutual Funds: Knowing When to Walk Away

This article originally appeared in the October 1998 *AAII Journal* and lays out timeless reasons for selling a mutual fund or staying put.

BY ALBERT J. FREDMAN

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. 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.

What are the legitimate reasons for selling funds, and when should you stay 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. 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? Different



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benchmarks are available for different market segments and investment styles. Peer and index benchmarks are provided in AAI's annual "Individual Investor's Guide to the Top Mutual Funds" for each investment category and investment style.

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 performance against. Another possibility is to compare your fund's performance with an index fund that has roughly the same portfolio composition. 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.

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 against 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, or they may hate to deal with the tax consequences, or they are loath to expend the effort to fill out the paperwork and move to a new fund or fund family. The problem is that these individuals face a high opportunity cost by clinging to losing or mediocre funds.

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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 under-performance 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, an equal replacement may be hard to find. So take the exit of a star manager as a warning flag, but not an automatic sell. Finally, think seriously about selling if a fund has had more than its share of management turnover, because frequent changes are not healthy and constant shifting of a portfolio creates negative tax and transaction cost consequences.
- » **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 or index 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 ei-

ther. 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 with long-term capital gains taxed at lower rates. In addition, the long-term capital gains holding period is 12 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 (IRA) 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, and then reinvest in a peer fund that has better performance.

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. Check for redundancy in your fund portfolio: Funds with different names may in fact share the same objectives and investing style. 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 narrowly focused fund that makes you uncomfortable due to its risk, or any gimmicky fund

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that really doesn't add to your portfolio. A broad-based asset allocation fund is unnecessary if you've allocated your assets properly in the first place.

Suppose you hold a fund invested in an asset class that has done poorly even though the manager has fared better than the benchmark. In this case, 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 such as sector 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. 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.

Allocation Changes

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 large-cap stocks, small-cap stocks, foreign equities, bonds, money market funds and any subcategories. Recognize that your stock funds could plunge anywhere from 20% to more than 40% within a few months during a bear market. You might want to check and see how your funds and similar ones did during down 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 risk 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 con-

tinue to advance and you wish to make a more modest reallocation for the time being.

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 if you are uncomfortable with the risk level of your fund portfolio, 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.

Avoid Panic-Selling

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. But even if a bear market is long and painful, 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. 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.

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The Top Mutual Funds Often Don't Continue to Outperform by Charles Rotblut, CFA, March 2019

The Individual Investor's Guide to the Top Mutual Funds 2019 by AAIL Staff, February 2019

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