Market Dynamics

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Performance Management System

The Sell Decision Is Critical

Portfolios heavy with under-performing stocks almost never outperform the market.
Ignat's Law

"Society is always taken by surprise by any new example of common sense."

Ralph Waldo Emerson

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Most stock investors spend most or all of their time on the search for what to buy. Experience shows that concentration on the sell decision is even more important. This is counterintuitive and escapes many investors, especially academics who teach but do not manage investments.

The simple truth is that if you know which stocks need to be sold, you also know which stocks not to buy. The key to successful investing is knowing which stocks to avoid. It is equally important to know when a stock goes from a "buy" to a "sell."

Statistical analysis of historical returns from stock investments indicates that one/third of all stocks are trending down and are unsuitable for purchase. This analysis also indicates that one/third of all stocks are meandering back and forth within a long-term trading range and will probably be unrewarding as a long-term investment. The remaining one/third of all stocks are in persistent long-term up trends and will be suitable as a long-term investment.

The typical stock investor believes that stocks that have declined in price are better investments for the long-term. They are at bargain prices. This flies in the face of trend analysis that indicates that stocks going down are to be avoided. A stock in a downtrend is a stock that needs to be sold, not bought. The analysis of the persistent trend is what allows the investor to correctly evaluate the investment potential for a stock.

I do not think that I have ever seen a college textbook on investing that even included a chapter on which stocks to sell. The assumption seems to be that if the buy decision is done well, then the sell decision will take care of itself. Experience shows that this idea is totally wrong.

There seems to be little doubt that institutional portfolios under-perform their benchmarks because they hold stocks that under-perform those benchmarks. This is proof that they don't know how or refuse to make the sell decision. If they knew which stocks to sell, they would not hold these stocks with such bad performance.

Value oriented investors are especially vulnerable to this line of reasoning. They believe that the value of the stock is more or less constant and is probably increasing anyway, so buying stocks that are down in price seems to make sense. The problem is that the value of a stock based on its financial performance is not constant and it can change dramatically, even in the short run. There is also the situation where the stock may be subject to fraud and manipulation and ideas of historic value can be very misleading.

All investors need to develop an ability to evaluate the trend of the stock's performance. If the performance is bad and that bad performance persists, the investor needs to believe that this is a stock that should be sold, not bought. The stock may be cheap relative to recent prices, but it is probably not a bargain.

An investor who focuses on the sell decision will correct this misconception. A byproduct of knowing which stocks to sell is that the investor also knows which stocks not to buy. Knowing which stocks not to buy eliminates the majority of stocks from consideration as a long-term buy.

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