Safal Niveshak

WHEN TO SELL A STOCK

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When to Sell A Stock

Most investing discussions revolve around when to buy a stock. "Which stock should I buy?" is the first question that comes to your mind when you think about investments. But equally important is the question – When should I sell a stock?" Now, there aren't any "10 Immutable Laws of Selling." In fact, the answer to this question is often as difficult and subjective as deciding when to buy a stock.

But, without doubt, a disciplined sell process injects a healthy dose of Darwinism – survival of the fittest – into the portfolio. This process weeds out the weakest stocks – the ones that have deteriorated / deteriorating fundamentals or diminished margins of safety – in favour of stronger ones.

In this special report, I try to answer some of the questions around when to sell a stock. Not every selling rule under the sun may be included herein, but I'm sure what you read below will still be of some help to you.

Barbara Streisand, an American singer and actress found a new occupation for herself in 1999, during the heydays of the dot com bubble. She became a stock picker. What's more, she started managing funds of her close friend Donna Karan, a leading US fashion designer, of the DKNY fame.

Times were so good then, that in just five months of intense trading, Streisand turned Karan's investment of US$ 1 million to US$ 1.8 million.

Now, for all her dabbling in the risky territory of stock trading, Streisand admitted that the volatility made her nervous. As she confessed then to a friend, "I can't stand to see red in my profit-or-loss column. I'm Taurus the bull, so I react to red. If I see red, I sell my stocks quickly."

Well, for a die-hard fan of Streisand or a stock trader, this rule of selling stocks – whenever they are in the red – may sound like a gospel truth. In fact, some of the smartest and most successful traders would agree to the fact about cutting their losses as soon as possible.

But if you are a long-term investor, selling a stock as soon as you see red can be a dangerous activity. Why dangerous? Simply because you lose out on the opportunity of benefiting from any compounding that that stock can achieve over the next 5-10 years, in case the underlying business has such potential.

"When Should I Sell My Stocks?"

This is one of the most frequently asked questions I've received over the past few months, and is surely a sign that surging stock prices is making a lot of investors edgy. Now, isn't it ironical that we all invest in stocks to see their prices rise, and when they actually rise, we get nervous and itchy to cash out?

So, a lot of people, even long-term investors who would buy a business promising to hold on for "at least 10 years", would sell as soon as the stock multiplies 2-3x.

I have been a star at such price-based selling in the past. So I would sell stocks as soon as they multiplied 4-5x (Page Industries) or if they did not move for 2-3 years (Swaraj Engines). All this while, the only thing I looked at was the price of the stock and what it had done in the past.

Another irony here – when we buy businesses, we are forward looking, and when we sell, we are backward looking.

The lesson I've learned from several such episodes of either selling too early or selling due to not seeing action is that I now do not make my sell decisions based on my cost price. In other words, my cost price does not matter when I'm looking to make any sell decisions.

What matters is my expectation from the business over the next 10 years or so. If the expectation is still good (of an expanding earning power), even after the rise in stock price in the past, I continue to hold on.

This is what I've learned from what Warren Buffett has said repeatedly…

We never buy something with a price target in mind. We never buy something at 30 saying if it goes to 40 we'll sell it or 50 or 60 or 100. We just don't do it that way. Anymore than when we buy a private business like See's Candy for $25 million. We don't ever say if we ever get an offer of $50 million for this business we will sell it. That is not the way to look at a business.

The way to look at a business is this going to keep producing more and more money over time? And if the answer to that is yes, you don't need to ask any more questions.

Not selling stocks just because the prices have moved up is probably something Buffett learned from Philip Fisher, who had these three simple rules of selling stocks –

1. **Wrong Facts:** There are times after a stock is purchased that you realize the facts do not support the supposed rosy reasons of the original purchase. If the purchase thesis was initially built on a shaky foundation, then the shares should be sold. More money is lost by people who've held on to bad, losing businesses hoping to get their money back some day.

2. **Changing Facts:** The facts of the original purchase may have been deemed correct, but facts can change negatively over the passage of time. Management deterioration and/or the exhaustion of growth opportunities are a few reasons why a stock should be sold according to Fisher. You must avoid the commitment bias here.

3. **Scarcity of Cash:** If there is a shortage of cash available, and if a unique opportunity presents itself, then Fisher advises the sale of other stocks to fund the purchase.

If you re-read what Fisher had to say about selling stocks, and combine it with Buffett's thoughts above, you'll know that both these

men are not talking about stock prices at all while deciding to sell stocks.

They are only talking about evaluating businesses at regular intervals and whether they will remain good for years to come, and then deciding what to do with the stock – to sell or hold.

As far as evaluating the business is concerned, my friend and value investor Ankur Jain writes this on his blog post on when to sell…

We should be asking questions to ourselves about the companies we own before considering selling the stocks.

Is the competitive advantage of the business better than before? Any deterioration in the bargaining power of the business? How are the growth prospects? Any foolish diversification attempted by the management? Can the business continue to scale up and deploy large amounts of capital at attractive rates of return? Change in the competitive landscape? Is it a better, larger and a stronger company now than when I bought the stock?

If the answers to these questions are largely in favour of the company in question, we know that the company is on the right track.

"But What If My Stock Gets Overvalued?"

Philip Fisher answered this question beautifully in his book Common Stocks and Uncommon Profits…

…another line of reasoning so often used to cause well-intentioned but unsophisticated investors to miss huge future profits is the argument that an outstanding stock has become overpriced and therefore should be sold. What is more logical than this? If a stock is overpriced, why not sell it rather than keep it?

Before reaching hasty conclusions, let us look a little bit below the surface. Just what is overpriced? What are we trying to accomplish? Any really good stock will sell and should sell at a higher ratio to current earnings than a stock with a stable rather than an expanding earning power. After all, this probability of participating in continued growth is obviously worth something. When we say that the stock is overpriced, we may mean that it is selling at an even higher ratio in relation to this expected earning power than we believe it should be.

All of this is trying to measure something with a greater degree of preciseness than is possible. The investor cannot pinpoint just how much per share a particular company will earn two years from now or whether a sizable increase in average earnings is likely to occur a few years from now.

He can at best just this within such general and non-mathematical limits as "about the same," "up moderately," "up a lot," or "up tremendously."

…how can anyone say with even moderate precision just what is overpriced for an outstanding company with an unusually rapid growth rate? If the growth rate is so good that in another ten years the company might well have quadrupled, is it really of such great concern whether at the moment

the stock might or might not be 35 percent overpriced?

That which really matters is not to disturb a position that is going to be worth a great deal more later. If for a while the stock loses, say 35 percent of its current market quotation, is this really such a serious matter? Again, isn't the maintaining of our position rather than the possibility of temporarily losing a small part of our capital gain the matter which is really important?

If the job has been correctly done when a common stock is purchased, the time to sell it is – almost never.

"So, Should I Never Sell My Stocks?"

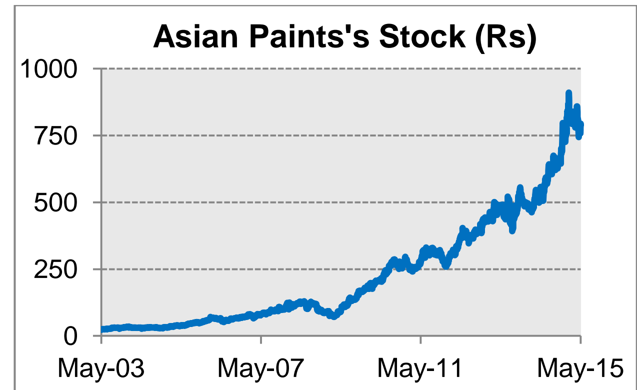
Well, you should never sell your stocks while looking at the stock price. Instead, look at the business and then decide whether you would want to be its owner starting that day.

In other words, treat each day you own a stock as the first day of owning that stock. And you should decide to keep owning it, or sell it, depending on what you expect from the business starting that very day and for the next 10 years.

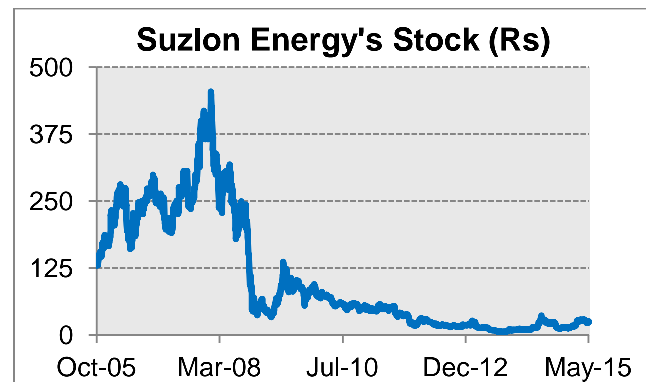
But again, please do not sell a stock just because…

- It has gone up 2x since your buying price; or
- It has surged 20% in the last one month; or
- You expect a correction and plan to buy the stock again at a lower price.

Take a look at this stock price chart of Asian Paints over the last 12 years. There have been several 2x rises, several 20% surges, and several corrections. But people who sold off this stock for any or all of these reasons during this journey, must be ruing their decision on seeing this chart.



On the other hand, I know a few people who hold on to their Suzlons and DLFs because they want to get their money back! (it's good to live with a paper loss that converting it to an actual loss, no?)



It's important to sell a stock if the business is going downhill, or if your original thesis was wrong (which will be the case many times).

Buffett said this about the stocks he never sells…

Our permanent holdings have three things in common:

1. *Fundamentally good characteristics.*
2. *Management that's very able and very trustworthy.*
3. *We like the company. We like what they do, find them interesting and like being associated with them.*

We feel about these permanent holdings the same way we do about our directly owned operations. We are not pure economic creatures in that respect. We're not going to make decisions based purely on economics.

And that policy penalizes our results somewhat, but we prefer to operate that way in life. What's the sense of becoming rich if you're going to have a pattern of operation where you continually discard associations with people you like, admire and find interesting in order to earn a slightly bigger figure?

We like bigger figures, but not to the exclusion on everything else…

It's easy to say that all of our holdings are all permanent investments as long as they're all doing well. But the real definition of a permanent investment is one that we'd hold through sickness and health…

And we do make certain exceptions…if a business ' problems will make it a long-term, drainer of cash, if we feel we've been Mickey Moused by management or if there are intractable labor problems, there's the possibility that we'd have a different attitude…

David Einhorn of Greenlight Capital says…

We try not to have many investing rules, but there is one that has served us well: If we decide we were wrong about something, in terms of why we did it, we exit, period. We never invent new reasons to continue with a position when the original reasons are no longer available.

But making a selling decision with an eye just on the stock price is a bad idea.

Especially when you own a terrific company, you don't want to sell simply because it is "fairly valued" today. That's because the company will continue to grow, and its earnings would be materially higher 10, 15, 20 years down the line.

Selling, An Emotional Decision

Selling a stock is often an emotional process, often more emotional than buying. This is because after analyzing and holding a stock for some time, we tend to develop an emotional connection with it.

Selling brings closure to the journey, and if the journey was successful (the price has appreciated) you don't want it to end.

However, stocks are not pets. The stock doesn't know that you own it, and it will not hold a grudge against you for selling it.

As Lord Keynes suggested, when the facts (about the business you own) change (for the worse), change your mind (about the stock). Of course, this rare ability to draw back from one's circumstance and view it at arm's length, as a stranger might view things, is difficult. But for an investor, this is a valuable skill indeed.

The baggage of past decisions often haunts us when we attempt to make sell decisions. Selling a stock that is experiencing deteriorating fundamentals forces us to admit that buying that stock was a mistake. We have to accept that not every decision we make will work out. This is just the reality of investments.

Selling and Loss Aversion Bias

We hate losses. We are willing to risk losing everything (from falling stocks that might never come up due to deteriorating underlying businesses) if there's a chance they might lose nothing ("I think this stock will rise again!"). This is called as loss aversion bias.

Since the noted psychologist and behavioural economist Daniel Kahneman began studying loss aversion in the early 1970s, it has been used to explain a stunning variety of irrational behaviors, from the misguided decisions of investors to the stickiness of housing prices in the aftermath of a housing bubble (builders and owners are not ready to sell their houses at 'loss' even if there's little hope that the prices will rise again).

Loss aversion is also used to justify our fondness for the status quo. "The present may stink, but I still don't want to lose it," we would comfort ourselves during adverse times.

Now, what makes us averse to losses? One reason is regret.

We often regret a bad outcome, such as a stock that has fallen after we bought it. This is despite the fact that we know we chose the investment for all the right reasons. In this case, what regret can lead you to do is to make a poor 'sell' decision. You may end up selling a good company at a market bottom instead of buying more of it.

Alternatively, if it's a bad company and you realize it after you buy it, you regret being proved wrong in your original judgment. So to avoid being called 'foolish' by your friends and colleagues, you hold on and continue to silently suffer the loss.

Another factor that makes you averse to losses is the 'sunk cost fallacy', which leads us to think…

It's now too late! I'm already down 50%. Now I don't want to convert the paper loss into real loss by selling the stock. And then, I spent so much time and energy finding this stock. Let me wait for some more time for it to come back to my cost price and then I'll surely sell.

So you end up with a situation where just because you have put a lot of time and energy into the selection of the stock, even when you realize that you must sell it, you are afraid to cut it loose.

In Why Smart People Make Big Money Mistakes and How to Correct Them, the authors write –

Once your money is spent, it's gone. It has no relevance. To the extent you can incorporate that notion into your financial decisions, you'll be that much better off for trying. If you're debating the sale of an investment (or a home), for example, remember that your goal is to maximize your wealth and your enjoyment. The goal is not to justify your decision to buy the

investment at whatever price you originally paid for it. Who cares?

What counts, in terms of getting where you want to be tomorrow, is what that investment is worth today.

The crux of this is that you must learn to walk away from bad investing decisions you made in the past. Just get over that 'I can't quit' trap!

Your sunk cost is already sunk in the past. Now, don't sink your future worrying about it.

So, while making the decision to sell a stock, forget about what you paid for it. This is because what you paid for a stock has no bearing on the future price. Only consider what the approximate intrinsic value is today.

Ask yourself, "If I didn't have these shares, would these be worth buying now, at today's price?"

If not, then sell it now. Don't let your ego ruin your investment returns. You've already had it enough!

Anyways, Philip Fisher was very aware of the problems that loss aversion bias can cause. He wrote in his book –

There is a complicating factor that makes the handling of investment mistakes more difficult. This is the ego in each of us. None of us likes to admit to himself that he has been wrong. If we have made a mistake in buying a stock but can sell the stock at a small profit, we have somehow lost any sense of having been foolish.

On the other hand, if we sell at a small loss we are quite unhappy about the whole matter. This reaction, while completely natural and normal, is probably one of the most dangerous in which we can indulge ourselves in the entire investment process.

More money has probably been lost by investors holding a stock they really did not want until they could 'at least come out even' than from any other single reason.

If to these actual losses are added the profits that might have been made through the proper reinvestment of these funds if such reinvestment had been made when the mistake was first realized, the cost of self-indulgence becomes truly tremendous.

First Sell…Mentally

This is one of the most important things I learned from my 2012 interview of Prof. Sanjay Bakshi – when I asked him how he dealt with value traps – stocks that you consider cheap, and that get cheaper for fundamental reasons.

This is what he said…

The first thing to do is to recognize it (that value traps exist). Many people find this hard to do. They go into denial.

If something you bought has gone down 50%, something is wrong either with the market, or maybe something is wrong with you. And it's not a good idea to assume that the market is wrong. It's often wrong, no doubt, but not always.

Look at the fate of folks who bought into DLF, Unitech, Lanco, Rcom, and Suzlon in Jan 2008 and who are still holding those

stocks (July 2012). Here are the stock price returns from 1 Jan 2008 till date (July 2012): Lanco: -85%, DLF: -80%, Unitech: -95%, Suzlon: -95%, RCom: -93%.

People, who held on to these names since 1 Jan 2008 – at some point, they went into denial. They kept on inventing new reasons to own these stocks even though the original ones were no longer valid.

People need a way to de-bias themselves and one good way to do that is to mentally liquidate the portfolio and turn it into cash and then, for each security, ask yourself, "Knowing what I know now, would I buy this stock?"

Often the honest answer would be a most certain "no". Then the next question you have to face is – "Then why do I own it now?"

You have to deliberately expose yourself to cognitive dissonance and then you have to learn to promptly resolve it.

I used the above names as examples even though none of them were value stocks. But the same rules apply to value stocks, which turn out to be value traps. You have to recognise it which will expose you to cognitive dissonance, and then you have to rationally resolve the dissonance. And there is only now way to resolve it rationally – swallow your pride and sell it.

You see, your investments are about only one thing – the benefit you can derive from them in the future. The past is past. You did what you did, and lost what you lost.

Now, either you bang your head against a wall or do anything else to punish yourself for your past mistakes, but you can't recover what you lost.

The future, though, is wide open in front of you, inviting you to give your best shot. Of course, you don't know what your future might hold – positive or nasty surprises – but at least you have a chance to mould it as well as you can.

That's why you must mentally liquidate your present portfolio that was created in the past, so that you can change things to have better control over the future.

Now, there are three reasons why mentally liquidating your portfolio from time to time is such a liberating feeling…

1. You may get over your bias to hold on to past losses in hopes of recovering those losses.

2. You may realize that if you honestly and objectively expect that your current stock – including the one that dropped sharply recently – will do better than any other stock you can think of, then it's a good investment to hold on to. Otherwise, you "actually" sell it.

3. Mentally liquidating your stocks may help you answer this question well – "What's the best investment I will make now with this ready cash in hand?" So you may actually end up selling stocks where you are losing my night's sleep, and replacing them with others from your watchlist, which are better quality businesses and also available cheap.

It's not just important to consider the above-mentioned positives of mentally liquidating your stocks, but also these two negatives:

1. You will be bearing a transaction cost (broker commission) by actually selling a stock.

2. You may end up selling a good business that is just facing an uncertain economy and nervous investor behaviour. So while you may be getting a chance to buy more of that stock at a cheaper price, you may end up exiting it altogether, and thus miss out on a great potential.

Finally, you see, it's not easy to admit our own investing mistakes, simply because we don't want to convert our paper pain and losses to actual pain and losses. So whatever number of times I may ask you to cut your losses, the truth is that it's hard to do in practice.

But, as I have personally experienced, once you adopt the practice of mentally liquidating your investments from time to time, you get in the habit of viewing them more rationally.

This way, I'm sure as years pass, you'll see your performance as an investor improving. Plus, the habit of mentally liquidating your stocks from time to time should liberate you from your past decisions and focus on the future.

Swallow Your Pride

Someone rightly said that we're not rational animals, but rationalizing ones.

We will easily go to extremes in order to fool ourselves into believing that we're right about things about which we are really wrong. We will also get obsessed with what it cost us to buy an investment – the sunk cost fallacy.

So when we make an investment, the cost we pay for it is not just a financial commitment made by us, but also an emotional commitment ("Come what may, we shall never part!").

We like to think we were right. So if the price of a stock moves up after I buy it, I will take it as an evidence of my intelligence and investing skills.

However, if a stock falls well below my cost, I will overlook the negatives about the company that I may learn subsequent to my purchase. I will cheat myself into believing that the adversity my company is facing is only of a short-term nature, and that it's only a matter of time when the stock will soar.

Josh Billings, an American humorist of the nineteenth century, said…

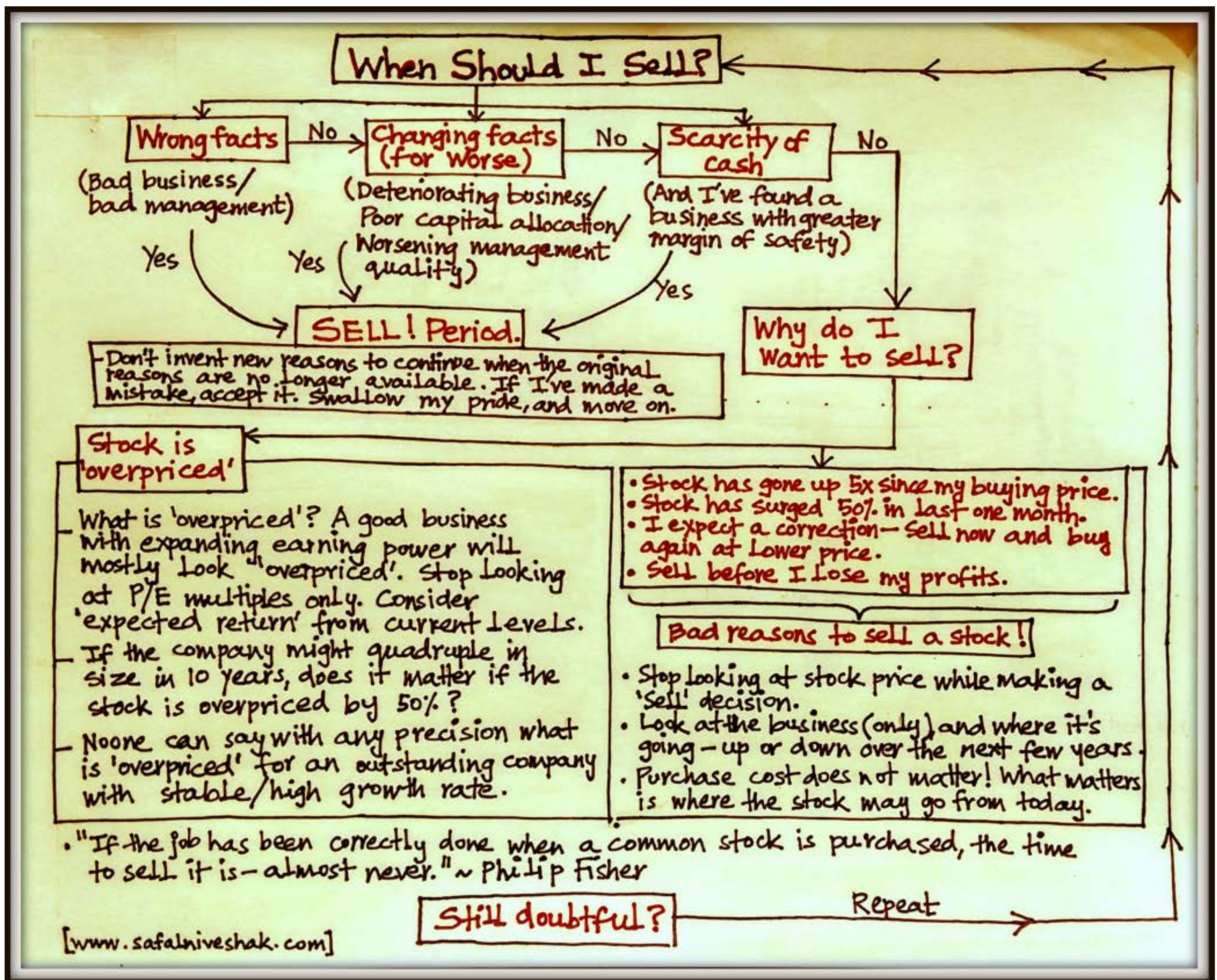
It ain't ignorance causes so much trouble; it's folks knowing so much that ain't so.

Unfortunately, too many investors have this idea that stock prices react to gravity – if they have been rising, it must mean they are due to fall soon. But always remember this – As long as the business remains great and you believe in its underlying fundamentals, there is no reason to sell any more than is necessary to rebalance your portfolio.

The reason to own a stock is that you want to become a partner in a great business. That's the formulation of Buffett's mentor, Benjamin Graham, and it is the starting point of all market wisdom. And then, you need to know what makes a business great. If you do, it will be much easier for you to determine when the business is no longer great and it's time to sell the stock.

But please, please don't sell stocks like Barbara Streisand as soon as you see red…even if you are Taurus the bull!

"When to Sell A Stock" Checklist



What Now?

Thanks for reading this e-book. I hope that you've found the process to be a helpful one that has given you some ideas on how and when to make (and when not to make) your stock selling decision.

Now I'd like to ask you a small favour. Provided you've liked what you've seen in this e-book, kindly share it with your friends and colleagues who might be interested.

You can also invite them to sign up for my free e-letter on investing and personal finance – The Safal Niveshak Post.

Also, if you wish to read more of such deep stuff on investing apart from my blog, i.e., www.safalniveshak.com, you may want to sign up for my premium monthly newsletter on value investing, behavioural finance, and business analysis – Value Investing Almanack (VIA). Click here to know more about VIA and subscribe.

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Thank you!

With respect,
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