Take Stock – When Should You Sell?

Description

***Take Stock** is the Motley Fool Canada's **free** investing newsletter. To have future editions delivered directly to you, simply **click here now**.*

Dear Fellow Fools,

This week hasn't been very kind to Canadian investors. We're about 150 points down from last Friday's close (at the time of writing), and Tuesday in particular wasn't all that friendly.

Though this slide may not feel overly comfortable for most, there's no need to panic. In fact, as the title implies, we have a special treat in store to help you dispel whatever feelings this week may have brought on.

I've handed the keys to this week's letter over to Morgan Housel, an award-winning columnist for our sister site, Fool.com.

In this issue, Morgan tackles one of the most important questions an investor faces: when to sell a stock?

That question was sent in by a reader (thanks, Lisa!) using our "Ask a Fool" feature at Fool.ca. Keep your questions coming! We'll answer as many as we can, either in a future edition of Take Stock or in a dedicated Fool.ca post.

The address is CanadaEditorial@fool.com.

Now, over to Morgan …

When Should You Sell?

By Morgan Housel

The amount of wealth generated by the stock market over long periods of time is incredible. Every dollar invested in America's S&P 500 a century ago would be worth $445 today, even adjusted for inflation.

Alas, most of us don't have 100 years to invest. We may not have 20 years, or even 10. Most of us eventually need to think about selling stocks.

But *when* should you sell?

People buy stocks for one reason: They think they're making a good investment.

But people sell stocks for all kinds of reasons.

They sell because they think stocks are overvalued, or they're worried about future losses, or they need to fund their retirement, want to buy a new boat, send their kids to post-secondary education — the list is endless. And it makes a simple question like, "When should I sell?" more complicated than it sounds.

Two types …

There are generally two types of investors. One I call "transaction investors."

Transaction investors attempt to time the market. When selling, they try to get out before they think other investors will.

Most of these investors don't do very well over time. Their own biases fool them into thinking they can forecast the market, so they rack up high transaction costs, and rather than avoiding the herd they tend to *be* the herd, buying stocks when they're expensive and selling near market bottoms.

Type No. 2 … Fools can relate

The other type of investors I call "longevity investors."

Longevity investors don't try to guess where the market is going or attempt to sell before it falls.

Instead, their long-term goals guide their investment decisions. When longevity investors have many years in front of them to invest, they buy stocks.

When they need cash to meet their goals, they sell — regardless of what the market is doing.

And on average, they do better than transaction investors.

If there's one thing to remember about selling stocks, it's that you'll likely to do better over time by thinking more like a longevity investor and less like a transaction investor.

As financial advisor Carl Richards recently put it:

- Investing should be linked to your goals. It's not a game, not a hobby. I can't say this enough: You don't invest because the market is going up, or because it's fun; you invest because you want to meet some financial goal.

The same is true for selling.

Both Warren Buffett and Motley Fool CEO Tom Gardner have said their long-term investment results might be better if they had never sold a single stock in their life.

They are the ultimate long-term investors — their goal is to build wealth over the course of decades — and many stocks they have sold went on to be runaway winners.

When it’s time to go, it’s time to go

Now, there are times an investor should rationally sell even when they don’t need the cash. We’ll get to those in a second. But let’s first outline the worst — yet most commonly cited — reason to sell a stock.

Because it’s gone down.

A stock going down is never a reason in itself to sell.

Every company, even the most successful and well-run, will see their stock decline from time to time, often substantially. Buffett began buying shares of **The Washington Post** in 1973 for his company, **Berkshire Hathaway**. Soon after, the stock fell 20% and stayed there for three years.

This would shake the faith of most investors to the core. But Buffett remained unfazed and continues to hold the stock to this day. When dividends are factored in, Berkshire has earned a 20,000% return on its investment in Washington Post.

It’s tempting to think a falling stock indicates trouble at the company you’re investing in, but that’s often not the case — remember, people sell stocks for all kinds of reasons, many of them having nothing to do with the company’s fundamentals.

Again, “stock is down” does not always mean “company is down”

Being tempted to sell a stock after it falls is actually one of the worst decisions investors make on a consistent basis. “Fluctuations unnerve investors,” famed University of Pennsylvania finance professor Jeremy Siegel said at a conference several years ago. “Why? Because people can’t stand them in the short run. Volatility scares enough people out of the market to generate superior returns for those who stay in.”

For long-term investors, there are three good reasons to sell a stock when you don’t need the cash to fund your goals.

1. You realize you don’t understand the company

We all make mistakes. Sometimes you buy a company because you like its business model and think it has a bright future. Then, something happens to make you realize the company is far different than you imagined.

I owned a few big bank stocks last decade, and sold around 2008 not because their shares were falling (and they were), but because I realized the way they earn money, manage risk, and account for losses was far different than I assumed and beyond my comprehension. Don't try to convince yourself that you understand something you clearly don't.

Be honest with yourself and move on when humbled.

2. It trades at a valuation you're not comfortable with

This is probably the best reason to sell. And while the topic of valuation can hardly fit into a book, let alone an article, the basic theory is that you don't want to own a company where good news is already priced in.

For large and established companies, try this (rough) guide: Take a company's annual free cash flow and divide it by its market capitalization. That's its free cash-flow yield.

Would you be happy earning it as an annual return? If so, good. If not, consider moving on.

3. There's a fundamental change in the industry

Things change over time. Investing would be easy if every company were like **Coca-Cola**, making the same product today as it did a century ago. But few do.

Paradigm shifts in industries occur that can upend your investment thesis enough to justify selling a stock.

Horse and buggies were a great industry until the automobile, cassette tapes were a great industry until the CD came along, and CDs were a great industry until digital took over.

Rarely do companies in declining industries make good long-term investments, regardless of how cheap they can be purchased for.

If you're invested in a company that fits this bill, it might be time to bite the bullet.

Foolish bottom line

In the end, the broadest answer to the question of when to sell is: "As little as possible, and with a clear and calm head."

Throughout history, the best investors haven't been the smartest or those with the most information — and certainly not those who sell the most — but the most patient.

When asked what made Berkshire Hathaway so successful, Charlie Munger explained succinctly: "It wasn't hyperactivity, but a hell of a lot of patience."

Wise words to consider.

Morgan Housel owns shares of Berkshire Hathaway.

Until next time …

Many thanks to Morgan for helping us out. One quick reminder: Be sure to follow us on Twitter and Facebook for all the latest in Foolish investing.

'Til next time … happy investing and Fool on!

Sincerely,

Iain Butler

Senior Analyst

Motley Fool Canada

CATEGORY

1. Investing

Category

1. Investing

Date
2025/09/25
Date Created
2013/08/29
Author
tmfohcanada