Why You Should Sell Your Losers and Buy Your Winners

Description

Many studies have been done on the psychology of investing, and, as it turns out, we are not as good as we think we are at picking stocks. Even the highest-paid money managers have difficulty beating the **S&P 500**; only a handful of the greatest investors of all time have able to do so consistently (Warren Buffett immediately comes to mind for most investing aficionados).

Among the range of biases investors often fall prey to, overconfidence and the gambler's fallacy, both of which tend to play together to produce sub-par results, stem from the long-held belief that stocks that have underperformed for some time will turn around, and those that have performed exceptionally well are less likely to do so in the future.

In 1985, De Bondt and Thaler wrote a peer-reviewed article on the reasons why contrarian investing can produce abnormal returns, theorizing that the abnormal returns seen in contrarian portfolios can be attributed to the ability of the contrarian investors to take advantage of the fact that investors, on average, overreact to information.

The idea that contrarian investors (those who sell winners and buy losers) can profit from other investors' overconfidence and overreaction to information has been challenged. A number of academics are pointing to the unique systematic risk profiles of the various contrarian portfolios as well as the effect of size (contrarian plays such as **Sears Canada Inc.** (TSX:SCC) typically tend to be smaller on account of losing much of their value, as opposed to comparable "winning" stocks such as **Shopify Inc.** (TSX:SHOP)(NYSE:SHOP), which may be considered "bloated") as confounding variables.

Previously popular contrarian investing strategies, such as the "Dogs of the Dow," in which investors simply take the worst-performing stocks in a given market, cut off the bottom-most tranche of these stocks (i.e., the ones with real bankruptcy risk), and buy the rest, have since been disproved.

A number of studies have pointed to the performance of momentum investing (buying winners and selling losers) as a more profitable strategy in the long term for a number of reasons, including less risk of bankruptcy for worst-performing stocks, greater tax advantages for taking losses early, and the fact that stocks overreact to information means momentum investing can work over a long period of time.

The philosophical argument is that investors typically sell too early, looking to “notch a checkmark in the win column” and call it a day, taking their gain to the bank. Similarly, investors typically hold on to their losers too long, hoping to “win it back” and wait it out, rather than cutting losses and investing the money in something better (like one of the winners).

Bottom line

Investing is a psychological game, and reading much of the literature on the theory of investing can provide insight into how to go about building a portfolio and managing stocks over a long period of time. Perhaps the best resource on this topic, one which has been referred to numerous times by Warren Buffett (it is his “bible” of investing), is *The Intelligent Investor* by Benjamin Graham (it’s since been updated numerous times to provide more current examples).

Stay Foolish, my friends.

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