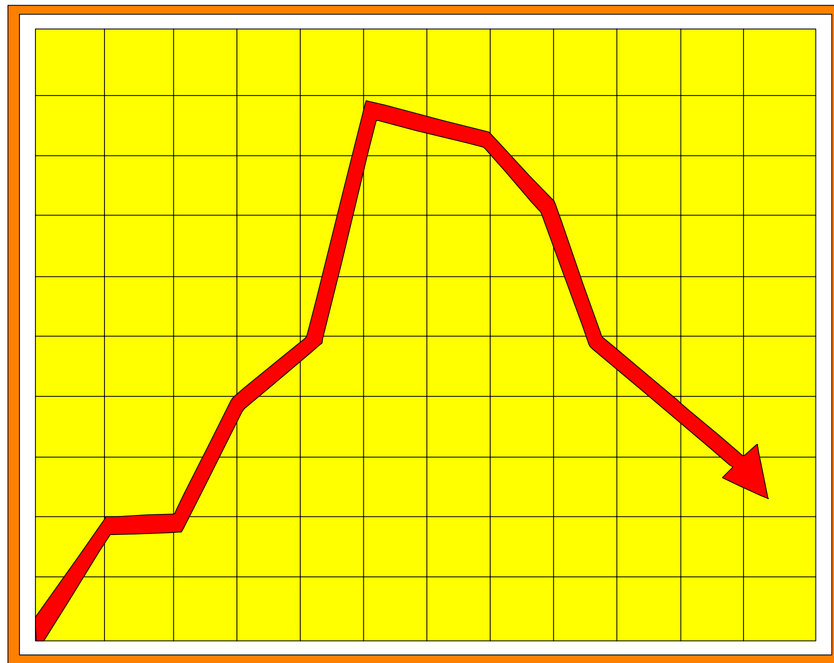
When to Sell a Stock

by Marco den Ouden



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Introduction:

When to Get Out of the Market

There is a multiplicity of information available on buying stocks. Books, newsletters, brokers, and sometimes even the cabbie or your dentist will have opinions on how to pick stocks, or even on specific stocks to buy.

But where can you find information on when you should sell a stock? Precious little is written about that! And even a writer such as William O'Neil, founder of *Investor's Business Daily*, who does offer suggestions on selling, focuses on the stock selection end of things.

In his book, *How to Make Money in Stocks*, O'Neil offers a number of pointers on selling and even goes so far as to list 36 "prime selling pointers". The number one pointer? "Buying right solves half of your selling problem".

O'Neil's specialty is growth stocks. But that pointer is also a prime consideration for another school of investing - value investing. This investment philosophy is often associated with the phrase "buy-and-hold". The idea is to select solid but undervalued stocks in the first place and hold them for ever, barring unforeseen circumstances. Their selling strategy is, basically - don't!

One of the prime exemplars of this school is Warren Buffett who topped Forbes list of the richest men in America in 1993. He was the only one who made his fortune through shrewd investment. Buffett doesn't have a ticker display in his office. Doesn't follow the stock market. Gives little thought to the state of the economy. His philosophy is to buy stocks as if you were buying the whole business. It's the continuing and growing profitability of the company and the soundness of its management that is key.

Buffett goes so far as to say that you could shut down the stock market for several years and he wouldn't care. It's the value of the business that counts, not the price that the stock market puts on it.

But other disagree. And even Buffett will sell some stocks if he perceives that they are greatly over-valued by the market or if he wants to free up cash to pursue an interesting opportunity.

Suggestions on selling include cutting losses short, selling half of your interest in a stock when it doubles, selling if a company's fundamentals deteriorate, using technical indicators such as moving averages or Bollinger bands to determine exit points and basing participation in the market on the action of broad indicators (otherwise known as market timing).

Elsewhere I've taken a tentative look at the idea of buying and selling the same security over a period of time when it advances 10% from a recent bottom or declines 10% from a recent top. With volatile stocks, such a system nets huge rewards, even if the stock is in a long run down trend.

Whatever method we choose, it is important to apply it consistently. As FundAdvice.com points out in an article called *Which is Better, Buy-and-Hold or Market Timing?*, some people who believe they are buy-and-hold investors are actually a perverse kind of market timer that the writer calls the ICSIA or "I can't stand it anymore" investor.

This, the writer points out (and probably accurately) is the worst *and* the most widely used investment system in the world. Such investors base their decisions on emotional reactions to the market. So when they see certain stocks going up and up and up, not jumping in because they fear the stock has already gone too high, they finally succumb when the stock is near its peak because they just "can't stand it anymore".

Of course, the stock then goes down the toilet and they don't sell, again fearing that this is a temporary correction and that the stock will rebound. Finally the stock falls so low that they (yes, you guessed it) just "can't stand it anymore". They sell and take their lumps.

And then of course, the stock finally rebounds, maybe even soaring to new heights. Instead of following the maxim of "buy low, sell high," they do the complete opposite. They buy high, and then sell low.

In the series of articles that follow, I will look at a variety of selling strategies. I'll explain what the strategy is, its strong points, and its drawbacks; the situations in which it proves useful, and the situations in which it does not work very well.

The strategy an individual investor uses should be tailored to the individual and her investment style. I'm not going to argue that one system is right and another wrong. My goal is to help you become familiar with these strategies so you can choose the one best suited to you. And it may be more than one system - an amalgam of several strategies. Only you can decide that.

But it is important to have a selling plan. Which plan doesn't matter so much. But have a plan and stick to it.

1 - The Buy and Hold Strategy

The selling strategy of what is commonly called the buy and hold approach to investing can be expressed in one word - don't! And the arguments in its favour are strong ones. For one, it has a solid record of success. Such famous names as Warren Buffett and John Templeton made their fortunes with it.

Or consider the remarkable case of Anne Scheiber. She represents, not only the superb returns that can be enjoyed from a skillful buy and hold strategy, but also the pluck to jump back in the game after losing everything.

In 1933 and 1934, at the height of the depression, 38 year old Anne invested most of her life savings in the stock market. She let her broker brother make the picks and they were good ones. Unfortunately, his company went bankrupt and she lost everything. But Anne did not give up.

On her modest salary as an auditor for the Internal Revenue Service (just over $3000 a year), she managed to save another $5000 over the next ten years. In 1944 she invested in the stock market again. When she died in January 1995 at the age of 101, that modest investment had grown to $20 million. That's not a misprint. $20 million! That represents an annual compounded rate of return of 17.5%, ranking her among the top investors of all time.

Her secret? Miss Scheiber invested in stocks of companies that she knew and understood; companies whose products she used. She loved the movies. So she invested in Loew's, Columbia, Paramount and Capital Cities Broadcasting. She drank Coke and Pepsi and bought shares in both. She invested in the companies that made medications she took - Schering Plough and Bristol Myers Squibb. And so on. And she hung on to them through thick and thin for over forty years. Through the bear market of 1973-1974. Through the crash of 1987.

Miss Scheiber left virtually the entire fortune to New York's Yeshiva University. By the time the estate was settled in December of 1995, it had grown to $22 million. You'll find links to her story and to investing tips based on her approach after this article.

The Buy and Hold approach to investing focuses on the buying, not the selling. The aim is to buy stock in companies that are solid and growing with long term potential. It focuses on the underlying value of the stock.

The approach is often considered synonymous with value investing. It ignores the stock market, the general economic climate, and prevailing sentiment.

Warren Buffett, considered by many to be the greatest investor of all time, has said that he pays no attention to the stock market, and in fact, would not mind if the market shut down for a few years. He buys stock in a company as if he was buying the entire company. It's the value of the company that interests him, not the value assigned to it by the market. He wants companies that generate consistently growing profits.

Value investors tend to focus on buying undervalued stocks. And value investing is not completely averse to selling a stock, though the preference is to hold. As the Templeton Fund puts it at their website, "Templeton buys stocks with the intent to hold them until they reach their "fair" value-- typically five years."

Buy and hold investors do sell when the fundamentals of a company change or when a stock becomes so grossly over-valued by the market that it would be foolish not to take profits. But in general, short term market fluctuations are ignored.

Downside to Buy and Hold

Of course, while buy and hold investing has definite advantages, there is a downside.

There have been major bear markets in the past and such markets tend to drag down *all* stocks, even those of good companies. If such risks can be minimized, wouldn't it be worth it?

The question is, can it? In the June 19, 2000 issue of the Hulbert Financial Digest, Mark Hulbert points out that there *are* newsletters which have been able to minimize investor losses during severe market corrections. Five in particular stand out. These five market timers were able to keep their readers' losses to one or two percent during each of the last five major market corrections since August 1987 (while the Wilshire 5000 averaged a 15% loss and the NASDAQ Composite lost 20%).

But...and here's the rub - those five newsletters failed to capture the tremendous gains made during the up cycles. Their average returns for the entire period from August 31, 1987 to May 31, 2000 ranged from 2.3% to 7.2% while the Wilshire averaged 14.3% and the NASDAQ 17.1%. Safety comes at a serious price!

In fact, Buy and Holders disparage the notion of market timing. It is folly, they say. And a pamphlet from the Templeton Fund in 1997 demonstrates that better than anything.

The Folly of Market Timing

In 1997, Templeton Funds distributed a fascinating brochure demonstrating the folly of market timing. It displayed two charts of investments in the Templeton Growth Fund from 1972 to 1996. Each chart showed the cumulative total of money invested and return generated if one had invested $5000 a year for that 25 year period.

Where the charts differed, however, was in the timing of the investments each year. One chart assumed the worst possible timing - when the Dow Jones Industrial Average was at its peak for the year. The second chart assumed the best possible timing - when the DJIA was at its lowest point for the year. The charts show the dates of the investments and the cumulative value of the investments at the end of each year.

What do you suppose the results were after 25 years? How much better did the accurate market timer do than the rotten market timer? Remember that the 25 year period included the bear years of 1973 and 1974. Do you think the accurate timer did twice as well as the bad timer? Three times as well? What about the average annual compound rate of return for each portfolio? Was the deviation greater than 5%, between 2% and 5% or less than 2%?

The answers will astound you. The cumulative value of the good timer's portfolio after 25 years was a staggering $1,719,702. And what about the poor slob who had the rotten luck to mistime each annual investment? Well, he wasn't such a poor slob after all. His portfolio accumulated to a staggering $1,427,872! Yes, even the worst possible performance of people who consistently added $5000 a year to their

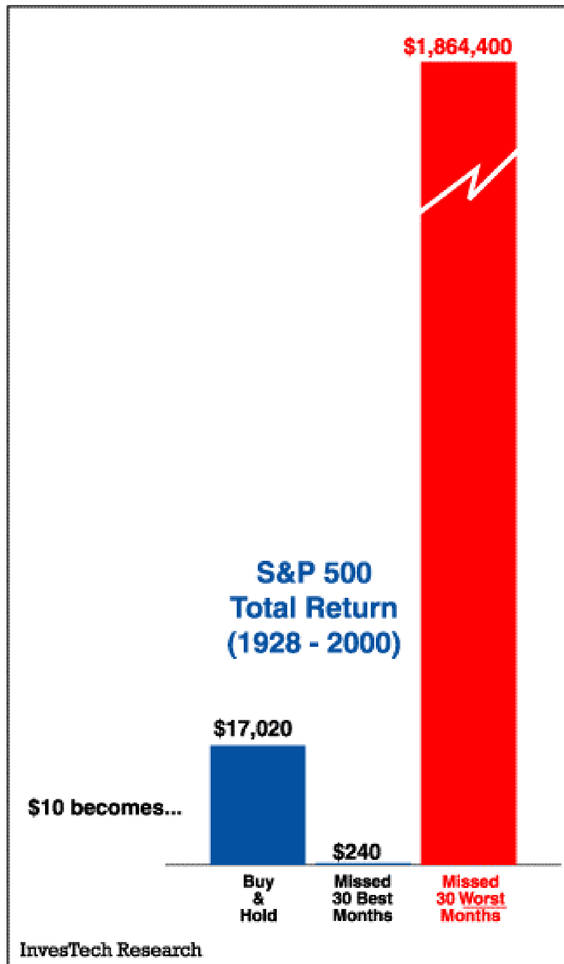
Templeton investment ended up with almost a million and a half dollars. Fully 83% as much as the person who had horseshoes up his butt. (And *nobody* is that good a market timer!)

Annual average compound rate of return? The accurate timer had an average annual return of 18%. The schmuck had 16.9%! You read that right. The deviation between absolutely accurate timing and absolutely atrocious timing was a measly 1.1%. And if someone were to follow the practice of dollar cost averaging, he would be somewhere between the two levels of performance with a likely deviation of less than half a percent.

Great Timer's Portfolio		Lousy Timer's Portfolio	
Value of Account	**Rate of Return**	**Value of Account**	**Rate of Return**
$1,719,702	18.0%	$1,427,872	16.9%

The Folly of NOT Market Timing

But before you complacently say "Yeah! You convinced me, Marco. I guess I don't need to read the rest of this booklet now." Consider this rejoinder to the folks who aver that stocks will always go up in the long run so it's better to buy and hold.



They're fond of trotting out a variation of the statistic noted by Hulbert – namely that by trying to market time, investors miss out on the big gains. They point out that from 1928 to 2000, for example, a buy and hold strategy would have turned $10 into $17,020. But if market timing caused you to miss the thirty best months in that 72 year period, your return would be just $240.

What they don't point out, however, is that by missing the thirty *worst* months, an investor would have turned $10 into $1,864,400. In other words, the upside potential of missing crushing bear markets far outstrips the downside potential of missing the best months.

This is graphically shown in the chart at left from Investech Research.

The point is this: While buy and hold has a very strong and respectable track record, and while successful market timing can be difficult, the upside potential of successfully missing major downturns is staggering. And as the bear market of 2000-2003 has shown us, not missing those downturns can be very painful indeed!

Summary of Advantages and Disadvantages of the Buy and Hold Strategy

Advantages	Disadvantages
Don't have to worry about the market.	Doesn't protect against bear markets and corrections.
Don't have to worry about the economy.	Stocks should be extensively researched and carefully chosen.
Don't have to pay attention to short term fluctuations.	Long term strategy.
Easy to manage portfolio.	No quick short term profits.
Ideally, don't have to sell at all.	
Notable success stories and history.	

Net Links of Interest

It's Never Too Late to Invest - a short account of the life and investment strategy of Anne Scheiber from the Motley Fool website.
http://www.fool.com/foolu/askfoolu/2002/askfoolu020507.htm

Landmark Scheiber Fund launched by Yeshiva University – October 2002 Press Release from Yeshiva University relates that the Scheiber Fund has now gone through probate and the first scholarships will be awarded. The fund, incidentally, grew to $36 million while the courts worked out the details.
http://www.yu.edu/news/pressreleases/fall02/scheiber.html

2 - Cut Your Losses Short

"Even being right 3 or 4 times out of 10 should yield a person a fortune if he has the sense to cut his losses quickly on the ventures where he has been wrong."

- Bernard Baruch

Did you ever buy a stock you were sure was going to be a winner only to watch it drop right after you bought it? So you think, "Hmm… I'm sure this stock is winner. The fundamentals are right. The momentum was right. I like the company's products. I'll just hang on and give it room to recover."

But it drops further. So you think, "Hey. How low can it go? It's got to start moving up again sometime." So you wait. And it drops further.

There are two problems with hanging on to a stock that's gone down since you bought it. One: the stock may be declining for some reason you're not aware of and may never go up again (or take a darn long time doing so.) and Two: the money invested in this stock could be invested in something else that's going up.

In his best-selling book, *How to Make Money in Stocks*, William O'Neil compares the situation to running a business, say a store selling women's fashions. If the store is selling a line of dresses in three colors, red, green and yellow, and the red ones sell out quickly, half the green ones sell, but the yellow dresses don't move at all, what does the merchant do?

Does she order more yellow dresses? Does she tie up more money in inventory that is not selling? No! She puts the yellow dresses on sale. And she keeps slashing prices to get rid of them. She wants to get her money out of the "dogs" and put them into buying more of the hot sellers.

Well, investing is a business too. And if your stock is a dog, sell it and move on.

Yet this is probably one of the hardest things for an investor to do. Many, if not most people, get emotionally involved in their stocks. If "their" pick does not pan out, they do not want to admit failure and defeat. They want to hang on and be vindicated. Yeah! I'm smart. My stock came through after all!

But it is not a reflection on you at all. A stock does what a stock's gotta do. If the market dictates that the stock go down, even though you're sure it should be going up, don't argue with the market. Don't take it personally.

The business woman doesn't take it personally that her yellow dresses aren't selling. She takes action to rectify the situation. So should the investor.

The Recovery Trap

There is another reason you should take losses quickly if they develop, and that is the ability to recover losses. If a stock drops 10% from the purchase price, you can make it back with an 11% gain. If it drops 20% you can make it back with a 25% gain. But if it drops 50%, your stock must gain 100% just to break even! Check out the table on the next page for the sobering numbers.

Amount Stock Drops	Gain Needed to Break Even
5%	5.26%
10%	11.1%
20%	25.0%
30%	42.86%
40%	66.67%
50%	100%
60%	150%
70%	233.33%
80%	400%
90%	900%

When you consider that a 25% return on investment is considered a good return, and how rare it is for a stock to gain 100%, let alone 900%, it should give one pause as you watch your favorite stock keep dropping.

During the bear market rout of from March 2000 through October 2002, many stocks dropped 50% to 90% and some, Nortel for example, dropped over 99% (Nortel dropped from a high of around $120 to under $1). Many will *never* recover their former heights - or certainly not soon. The poor sap who bought at the top of the market would have saved his bacon by selling quickly when the market turned. In fact, he could have bought far more shares of the same stocks after the market bottomed than he would have had by hanging on.

How Big a Loss Should You Take?

William O'Neil recommends selling any stock in which you have developed a loss of 7% or 8% of your cost. He emphasizes that this should apply only to stocks in which you have developed a loss. He does not mean you should sell stocks which are ahead but which have dropped 7% or 8% from their peak. Once you are in a profit position, you can give the stock some more leeway in price fluctuation.

The editors of the *Cabot Market Letter*, Timothy and Carlton Lutz, recommend selling immediately if you've sustained a 20% loss. It is not unusual for their newsletter to issue a sell recommendation on a stock they only recently recommended. On the other hand, they believe in letting their winners run. They, like O'Neil, are more tolerant of fluctuations in the price of a stock in which they are ahead.

Henry Ford (no relation to the auto Fords), the developer of The Pitbull Investor, a modified CANSLIM approach to investing, emphasizes the point. "Always know before you invest what the triggering event will be to get you out," he says. He recommends not accepting more than a 5% to 10% loss on any individual investment. In fact, he even recommends placing hard limits on how much of a drop from a stock's peak price you should accept.

Downside to Cutting Losses Short

The only real downside to cutting losses short is that the stock you just sold may turn around on a dime and go straight back up again. It may be annoying, but not nearly as annoying as watching the stock fall further.

In any event, you're not rolling over and playing dead. Once you've gotten your money out of a losing stock, you should be looking for another opportunity to put the money back to work again.

AND... there's no reason you can't buy back into the same stock again when it recovers. You may even be able to do so at a lower price.

Summary of Advantages and Disadvantages of the Cutting Your Losses Short Strategy

Advantages	Disadvantages
Preservation of capital.	You're taking a loss.
Money not tied up in a stock going nowhere.	Hey! It may go up again!
Peace of mind.	

Net Links of Interest

Selling Stocks to Cut Losses - Excellent series of articles on this point from *Investors Business Daily*.
http://www.investors.com/learn/s01a.asp

Cabot's Ten Rules for Investing in Stocks - See Rule # 7!
http://www.cabot.net/10rules.htm

The Pitbull Investor - This is a modified CANSLIM approach to investing.
http://www.pitbull.com/

3 - Sell Half of a Stock That's Doubled

Investing entails risk. But what if you could eliminate the risk in some of your investment? Wouldn't you want to do so?

In fact you can if you are fortunate enough to have a stock that's doubled in price. And that is the basis for the strategy of selling half of your investment in a stock that's doubled. By doing so you recoup 100% of your initial outlay and have a risk-free ride on the remaining stock.

This is a very popular selling strategy followed by many people. And recommended by some analysts. Ryan Irvine and Brent Larsen at *The FutureStock Review* frequently suggest that "taking profits on at least half your position would be a prudent strategy" for previously recommended stocks that have doubled or more.

And Pat McKeough, who generally recommends stocks for the long haul, acknowledges that "it pays to apply the sell-half rule" to high risk stocks, "penny mines or junior technology companies that don't have any real profit history".

But what if you've stumbled onto the next Microsoft? McKeough says you can always buy more after the company becomes profitable.

There's another reason for applying this rule besides eliminating risk. And that is to re-balance your portfolio. Suppose you bought shares of a speculative but promising stock that doubles in a short period. All of a sudden it makes up a much larger percentage of your portfolio. Do you want to be that exposed to the possibility of a sudden reversal?

Suppose, for example, that you have a $100,000 portfolio and you have invested $5000 in a stock that suddenly doubles. Now it makes up almost 10% of your portfolio. If the price falls back to its original level, a distinct possibility, you've wiped out 5% of your portfolio value. But if you sell half when it peaks, a reversal still leaves you with a 50% profit, wiping out only 2.5%.

What to Do With the Proceeds

So you've got a stock that's doubled and you sell half. What now? What do you do with the proceeds?

You can eliminate your risk of losing your seed capital completely by re-investing it in fixed income securities. Not very profitable, but absolutely 100% safe. This might be a good strategy if you're close to retirement age, but still actively investing. Your nest egg is then safe, and the remaining stock is "mad money" to take a chance with.

More likely though, is that you are still a bit away from retirement. In that case, you would likely re-invest the money in another stock, thus diversifying your portfolio.

Variations

One variation of this strategy is to continuously repeat it. If the stock doubles again, sell half again. And so on.

Another: if you believe the stock you are invested in has *tremendous* potential, in other words, another Microsoft, Dell or EMC in their heyday, you can change the rule to "sell half on the triple" That way you lock in a 50% profit instead of just recouping your initial stake. Or you can "sell a third on the triple", recouping your stake and leaving twice as much to ride the stock higher.

McKeough makes a brilliant suggestion for people who have made a killing on a stock inside their tax-sheltered retirement plan (RRSP in Canada, IRA in the US). Sell half to nail down the profit, then swap some or all of the remainder outside the sheltered plan into your personal portfolio. The stock is recorded for tax purposes as being bought at the price it is swapped out at. So if it declines instead of going up, you have a tax loss you can declare against taxable capital gains.

In fact, if you swap out for a stock that has lost value but which you expect to gain, you get a tax loss right away without losing the stock. And if the stock recovers as expected, the gain is sheltered. The tax loss may even offset a gain that the stock you swapped out may make. Anything to keep your money out of the hands of the revenuers is a plus in my book!

Downside to Selling Half on the Double

There are a few downsides to selling half when a stock doubles. The main one is that you may be selling out too early. The stock may still have tremendous potential. If that is the case, you can console yourself in the fact that you still have half of your investment and you are participating in the bounty, though not as much as you would have by holding.

Another downside is that, maybe you should have sold all of it! Maybe the stock will decline back to its previous level. If that is the case, you're still better off than by not having sold half. You're still in a profitable position. It's just a reduced profit.

But the most serious downside is that you now become complacent about the shares you've hung on to because, after all, they're "free". It still makes up part of your portfolio and, although you may allow it more leeway in fluctuations, you should still have a selling plan if the stock sours. *Never* be complacent.

Summary of Advantages and Disadvantages of the Cutting Your Losses Short Strategy

Advantages	Disadvantages
Preservation of capital.	The stock could continue to rise.
Risk reduction.	The stock could go down. (You should have sold it all.)
Rebalancing portfolio.	Could become complacent about shares you keep.
Peace of mind	

Net Links of Interest

When Markets Turn Ugly, a Diversified Portfolio is Best - Article at The Street.com argues that selling half of a stock that doubles should be one of the cornerstones of a diversified portfolio.
http://www.thestreet.com/pf/funds/managerstoolbox/915282.html

Stock Market Traps and How to Avoid Them - Article at Canadian consumer watchdog site Straight Goods recommends selling half of a stock that's doubled.
http://www.straightgoods.com/item63.asp

Trading Tips from Outstanding Investments – Michael Schaeffer's Outstanding Investments recommends selling half when a stock doubles "without fail".
http://www.outstandinginvestments.com/tradetips.html

4 - Sell When the Trend Changes

"The trend is your friend."

- popular saying

The strategies you employ in selling may depend, to some extent, on the criteria you use in buying. A value investor would look at a stock's changing fundamentals. But if momentum plays any part in your buying decisions, you'll want to look at trends.

I'm not sure who coined the phrase, but there is a lot of truth to the expression "The trend is your friend." It's very popular with newsletter writer James Dines who quotes it in big letters in almost every issue of *The Dines Letter*. And my former Day Trading colleague at About.com, Rob Rak, swears by it. As does Ross Jardine, one of the founders of the Investors Online Toolbox. Other ways of expressing this thought are "go with the flow" or "don't swim against the tide".

And the principle is sound. Just as the physical law of momentum says that any object in motion tends to stay in motion in the same direction unless acted upon by some outside force, so too, a stock in a trend (i.e. - a stock with momentum) tends to keep going in that direction until acted upon by some outside force. In the world of stock prices, that outside force can be changing investor psychology, changing fundamentals, or some news. And as so often happens, the stock moves ahead of overt public awareness of such forces.

So you're invested in a stock that is moving up smartly. The trend is up. How do you know when the trend is changing? There are several different approaches.

Ways of Determining Trends

There are several ways of determining trends. The easiest is simply to look at a company's stock chart and see which way it's sloping. But no matter which chart you look at, you'll note that, in spite of an apparent general trend, there can be fluctuations up and down within the trend. There are long term trends and there are short term trends. Look, for example, at the chart for Starbucks from Feb. 1, 2002 to Feb . 1, 2003 below.

The stock was in an uptrend through to the end of June followed by a sharp downtrend to the end of July, another uptrend through to the end of October and yet another downtrend the third week in January at which point another sharp uptrend was started.

Such a wildly a wildly fluctuating stock demonstrates that trends can run for months or for just weeks.

How can you tell when a trend is changing? We'll look at several options.

Trendlines

If you join the tops of the approximate peaks of a trending stock’s chart in a straight line and the approximate bottoms of the troughs in another, you have two lines running more or less parallel that chart a channel in which the stock is trending. When the stock price breaks below the bottom line, the trend is shifting. Either the stock is slowing in its rate of growth, or worse, the stock is turning and entering a downtrend.

Starbucks broke through uptrend lines in May, again in July and once more in November. The severe downtrend line was broken in August. And another downtrend line was broken in January. The latter was broken by what is called a gap up – a huge jump in price from one day to the next, usually a good sign.

Moving Averages

The moving average is another way of measuring trends. A moving average is a line plotted by taking the average stock price for a specified time period calculated daily. For example, the thirty day moving average is plotted from day to day by taking the average of a stock’s closing price over the last thirty days.

The simplest way of using moving averages to determine selling points is to simply take a single moving average, say 30 days as shown in the Starbucks chart by the red line, and sell when the stock price dips below its moving average and buy back when it moves back above the average. With our Starbucks example, this would have had you buying and selling the stock rather frequently as it went through several periods without a clearly defined trend. This is a rather costly exercise.

A better way would be to note the slope of the moving average. Sell when the moving average starts to turn down and buy back when it starts to turn up again. You could decide to give the stock a three day leeway - don't sell until the M.A. has been moving downwards for three straight sessions - to avoid excessive fluctuation. In our Starbucks example, this would have had you buy and sell five times.

Another alternative is to plot two moving averages, one for a short to mid-term period and one for a longer term trend and see how they relate to each other. Stock Trends is a subscription service that plots and analyses the thirteen week and forty week moving averages of stocks.

When the thirteen week moving average is above the forty week average, they consider that bullish. When it is below, they consider it bearish. Important indicators are crossovers - when the thirteen week M.A. crosses the forty week M.A., it may indicate a change in trend. But they also use trading volume as an additional indicator to determine the validity of crossovers. A bullish crossover on strong volume is a good sign, but weak volume negates it.

Many websites such as Globeinvestor, BigCharts or StockCharts.com let readers plot two moving averages against a stock's price. There you can do your own analysis of specific stocks against their moving averages. The use of moving averages is very flexible and the investor can tailor it to her preference by choosing a single moving average or two moving averages and choosing time frames she feels comfortable with. This may vary from stock to stock depending on the stock's history and volatility.

Bollinger Bands

Another method of determining trends was developed by market researcher John Bollinger in the late 70s and early 80s. It combines features of both trendlines and moving averages.

In the 70s some analysts started charting a variation of trendlines by creating a trading channel around a moving average instead of by linking peaks and troughs. But this proved to be less than adequate because they couldn't come up with a distance from the moving average at which to place the channel lines. The optimal distance varied from stock to stock depending on the stock's volatility.

Bollinger came up with the idea of charting two bands around the twenty day moving average that were two standard deviations above and below the MA. Standard deviation varies with volatility and this proved to be a very interesting and useful trend indicator as the bands widened during periods of great volatility and narrowed during periods of stability.

As with other indicators mentioned, a break below the lower band would be a selling signal.

Downside to Selling on Trend Reversals

As noted above, using trend indicators can have you trading in and out of stocks excessively if not chosen carefully. You may have to tailor the trend indicators to the stocks you own. But there is great truth in the maxim, "the trend is your friend", and the benefits far outweigh any disadvantages.

Summary of Advantages and Disadvantages of the Cutting Your Losses Short Strategy

Advantages	Disadvantages
Preservation of capital.	Excessive trading if not careful.
Risk reduction.	May have to tailor methods to individual stocks.
Peace of mind	

Net Links of Interest

Repeat after me: "The Trend is Your Friend" - Article by Jim Jubak at MSN Money Central.
http://moneycentral.msn.com/articles/invest/jubak/4800.asp

How Bollinger Bands Predicted Amazon's Moonshoot - Article by Randy Myers at MSN Central explains Bollinger Bands and gives a solid example of using the method with Amazon.com as an example.
http://moneycentral.msn.com/articles/invest/strat/2943.asp

Stock Trends - An analytical tool that allows investors to identify trends of stocks on the Toronto Stock Exchange.The methodology of this subscription service is carefully explained online.
http://www.stocktrends.ca/?page=sthandbook

5 - Sell When Fundamentals Falter

This may seem to be a no brainer, but it is often overlooked. You should consider selling a stock when its fundamentals change.

What are fundamentals? Ultimately, whatever your investing style, everything comes back to profits. Profits make the world go round and stocks go up. Without profits you just have a pocketful of dreams.

If you're invested in a speculative stock with no profits, you want to see growing revenues and decreasing losses as the stock must eventually become profitable. If these do not materialize, no matter how large or apparently successful a company is, it will falter and its stock price will fail. Witness the debacle that hit Priceline and a lot of other Internet stocks in the 2000-2002 bear market.

Amazon.com is one of the most successful of the new economy Internet companies. But it must show a profit some time. And not just a profit, but galloping growth in profits, to sustain its valuation. Investors will only sustain valuations if they see such growth as a realistic possibility. And indeed, we saw headlines like “Amazon Defends Strategy to Investors” when its shares were "battered by concerns over whether it will ever turn a profit" during the tech wreck. It's not surprising that Amazon plunged in the bear market.

Although there are a number of fundamentals one can look at, including price to earnings ratios and debt load, I'll focus here on two - revenues and earnings.

Revenues

If a company has been seeing growing revenues (and a growing stock price) and all of a sudden, revenue growth slows down or reverses in a quarter - watch out! It could be the harbinger of bad news for the stock price. How quickly a stock's price reacts to such bad news depends on a number of factors, including whether the company is, in fact, profitable.

If the company is profitable, it can probably sustain a bad quarter. They do happen occasionally. And the stock's price may remain buoyant, especially if there is an explanation for current woes and they are expected to be a temporary occurrence. But a second quarter of declining revenues often hits a company's stock price hard.

If the company is not profitable, a slowdown in revenue growth can halt the stock's advance, if not reverse the trend.

What is significant is how the revenue picture changes. A company that has been experiencing marginal growth and suddenly starts growing revenue by 30% a quarter will see its price gain. But a company whose revenues have been advancing by 60% quarter over quarter and sees growth slow to 30% a quarter will see its stock price falter. And if its market valuation has been built up by expectations of continuing high growth, the stock price will retreat.

In both cases, the company is experiencing 30% growth for the quarter. But the effect this has on stock price depends on previous history. Revenue must be looked at in the context of the company.

Earnings

Then there are earnings, or profits. Ultimately, these are more important than revenue growth because the sustainability of the company depends on it. Companies without profits "burn" through money. To survive they must refinance or turn the company around.

In the dot-com world, much was written about burn rates. And some dot-coms were devastated by high burn rates and slow revenue growth. Witness Dr. Koop, Book4golf.com and others.

If a company is not yet profitable, it must show rapidly declining losses - a trend that will ultimately put the company into a profitable position. If losses accelerate or even remain steady, the company will eventually hit the wall.

Investors will tolerate losses if they see a light at the end of the tunnel. But they don't like to wander around blindly. No light, no support.

If the company is profitable, then it fits either of two categories - a mature company whose profits are steady and reliable or a company that is growing.

Mature companies are often bought for their dividends, an opportunity to share in the company's fortune. These are blue chip stocks, old stalwarts. The stock price of these companies are usually fairly stable or they grow at a modest rate as the company plows some profits back into operations or the value of the company's assets increase in value.

But if such a stalwart experiences a reversal, the rock becomes slippery. The stock price can drop considerably. No stock, even a supposedly old reliable one, is immune to failure. Just look at the constantly changing makeup of the Dow Jones Industrial Average. Old stocks are dropped and new ones added as the economy changes. There are no buggy whip companies on the DJIA!

What about fast growing companies whose profits are growing steadily as well? Here risk sometimes increases as the growth of the stock price often outstrips the growth of the company. A slowdown in growth, or worse, a decline into a loss, will kill the stock price.

One of the buzz words today is "earnings surprise". A negative earnings surprise almost always sends a stock price dipping.

The key here, as with revenues, is to compare current quarterly results with past results *and* with expectations. Failure to meet the Street's expectations is a killer.

Always keep your eye on revenues and earnings, comparing them to the past and to expectations. And if warning signs appear - prepare to bail out.

Downside to Selling on Faltering Fundamentals

The only danger of this method is that the company may be experiencing a temporary setback that will quickly reverse itself in the near future. You must be careful to determine the reasons for a decline in revenues or earnings. If they are because of one time costs, re-organization, or increased R&D spending, the problem could be short-lived, if indeed there is a problem at all.

You should consider adopting a cautious stance after one bad quarter, but sometimes it's better to wait for a second bad quarter for confirmation before selling.

Summary of Advantages and Disadvantages of Selling on Faltering Fundamentals

Advantages	Disadvantages
The soundest methodology.	Company's setback could be temporary.
Risk reduction.	Hidden but acceptable factors could account for setback.
Preservation of Capital.	

6 - Sell When a Blow-Off Top Occurs

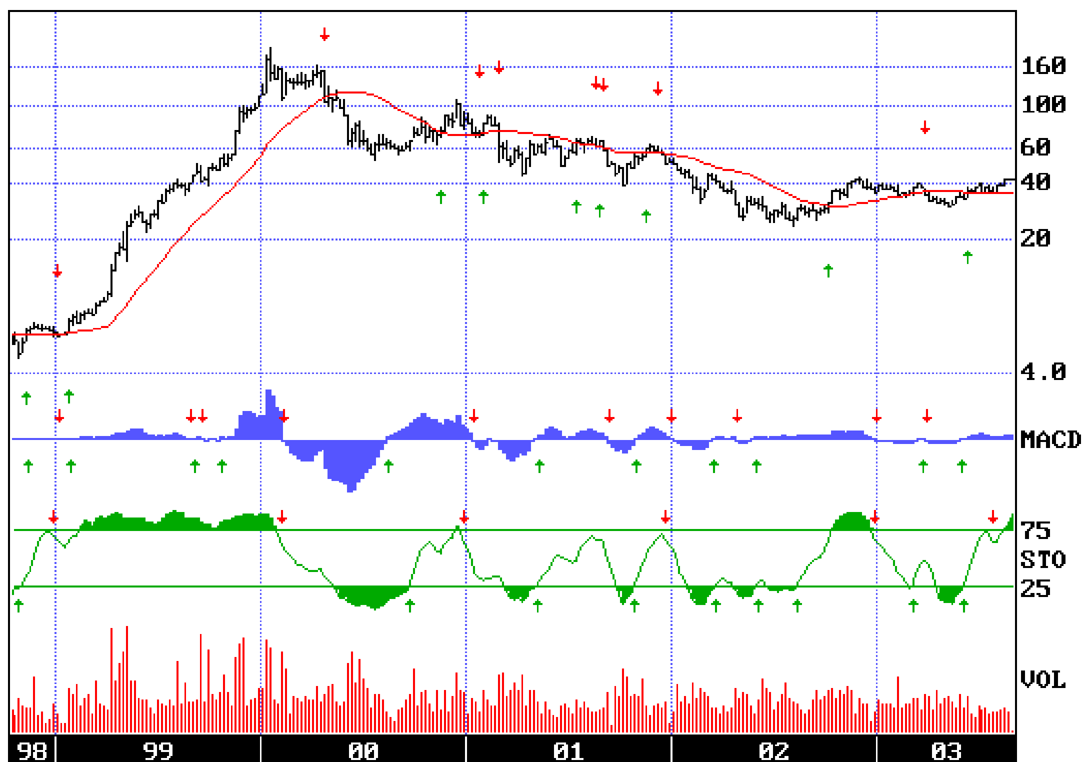
I like to call the blow-off top "my friend Spike" because the pattern is so easily recognized after the fact by the distinctive spike in the chart.

Sometimes a stock advances very quickly in a short period of time - days or just a week or two. It contrasts sharply with the previous action of the stock which may have been advancing steadily for some time. All of a sudden there is a sharp spike upwards. This is called a blow-off top. And it is a good point at which to sell.

What is happening here is that all of a sudden, everyone and his uncle has discovered the stock. Maybe a new analyst report touts a much higher target for the stock. Or a recent excellent quarterly report gets noticed. Or some exciting news has caught the public's imagination.

In any event, everyone decides they better get in on this stock before it's too late. Blow-off tops are usually accompanied by a large increase in trading volume, reflecting this surge of interest. The problem is, at that point, it's already too late.

The best way to understand this is to look at an example. Consider one of the best performing stocks of 1999 - Qualcomm (QCOM - NASDAQ). This stock just rose steadily for most of the year. Then, in mid-November and at the end of December, the stock took flying leaps upward.



Each case was accompanied by increased trading volume. In the first case, QCOM jumped from 224.81 on Nov. 2, 1999 with a volume of around 5 million shares to 260.50 the next day on volume of around 14 million shares. That's a 15.9% jump in one day. The company issued a strong quarterly report on that day. And the stock

continued to soar - peaking at an intraday high of 406.13 on the 15th. Total gain in two weeks - 80.7%.

The stock then moved sideways for a while before starting another steady climb. On Dec. 29th, with the price at $503, Paine Webber analyst Joseph Galone initiated coverage with a Buy rating and a target of $1000. The market went nuts. The volume tripled the next day and the stock surged ahead to $659 - a gain of $156 or 31.0%. Everybody believed Galone.

The following day saw the stock surge to an intraday high of $740.13 only to drop back and close at $647. The next day - the last day of the year - the stock split 4-for-1 and surged again to close at a pre-split price of $704.52. Then on January 3, the first trading day of the New Year, the stock surged ahead to an intraday high of $800 pre-split and a closing price of $717.24.

And that was it for Qualcomm. The stock never regained that heady high. Those hanging on waiting for that magic $1000 figure were treated to a drop of 75% by mid-July 2000.

What to Look For

So how do you spot a blow-off top? Why was the November surge a natural step-up and the second a blow-off top?

Actually, the November climb could have been a top. A surge of that magnitude can go either way. And many such surges are steps along the road to further gains. A stair-step pattern of surging gain, consolidation, surging gain, more consolidation and then more gain, is not uncommon. Very few stocks climb steadily and consistently upwards week after week like Qualcomm did for most of 1999 before November.

In his best-selling *How to Make Money in Stocks*, William O'Neil lists 36 selling guidelines, several of which relate to blow-off tops. They are:

- If a stock has a larger increase on a particular up day than on any previous up days, a top may be near.
- The heaviest volume day often coincides with a top.
- If a stock has a rapid price run-up for two or three weeks, it may be a blow-off top.
- If a stock runs up quickly for a week or two after a stock split, it may be a top.
- Stocks closing at the low end of a day's trading range during a run-up indicate a possible top.

In our example of Qualcomm, blow-off top signals were given with both the November and the December run-ups. Prudently, an investor could have sold right after the first run-up started to level off, and then bought back in when the stock once again hit new highs in early December. If the stock had broken to the downside instead of resuming its advance, the investor would have been covered.

Similarly, an investor should have sold right after the second day of the advance in December when the failure of the stock to hold its intra-day gains indicated weakness. Or, anticipating a run-up on the stock split, the investor could have sold right after the stock split when again, the stock couldn't close near its intra-day high.

Qualcomm had one other factor indicating a possible top in December - Galone's bold assertion of a $1000 target price. O'Neil reiterates Jack Dreyfus's admonition: "Sell when there is an *overabundance* of optimism."

Qualcomm is a superb example of the blow-off top, but there are many others. In fact, almost any high tech and/or Internet stock exhibited a blow-off top formation in late February and early March 2000.

The only reason people hang on to a stock after a blow-off top is simple greed. They aren't satisfied with their double, triple, or even ten bagger. They believe the gravy train will go on forever. It doesn't.

The only exception to the rule is a stock that is the subject of a takeover bid at a premium price. It may exhibit the sudden run-up in price typical of a blow-off top, but the price has no reason to fall back unless the deal falls through. And if the deal involves an exchange of shares, the thing to watch is the company taking over. If its shares aren't exhibiting a blow-off top pattern - then the shares of the company being taken over are safe to hold for the interim (barring other factors).

Downside to Selling on a Blow-Off Top

The only hazard of selling on a blow-off top is the possibility that the stock may, in fact, advance further as evidenced by the November 1999 jump in Qualcomm. But selling, with the possibility of buying back in when the stock hits a new high, is better than being caught with your pants down.

Summary of Advantages and Disadvantages of Selling on Faltering Fundamentals

Advantages	Disadvantages
Get out with a nice profit	Could be a stepping stone to further gains rather than an ultimate top
Avoid a sudden and drastic decline	Must be careful you don't sell a stock that's rising quickly on a takeover bid

7 - Deciphering Analyst-Speak

To say there is a distinct buy-side bias in the brokerage community is an understatement. Brokers and analysts rarely recommend selling a stock. At least not in so many words. But broker analysts do use buzzwords that, to the trained ear, clearly spell out "Sell".

On May 22, 2002, Merrill Lynch, the huge Wall Street brokerage firm, agreed to pay US$100 million in penalties to forestall criminal charges in allegations of breach of trust and fiduciary responsibility by the company.

The company had been under investigation by New York state Attorney General Eliot Spitzer for alleged conflict of interest between Merrill Lynch's analysts, who promoted stock issues to the public, and the company's investment-banking arm, which handled lucrative new stock issues.

It came out that analysts who wrote glowing reports on stocks being handled by the investment-banking arm often disparaged these stocks privately, sometimes even going so far as to call them "a piece of crap."

One such analyst was Henry Blodgett who quietly accepted a multi-million dollar golden parachute to leave Merrill. Blodgett became an Internet guru and one of the highest paid analysts on Wall Street during the dot-com frenzy. And true to form for many analysts, he just couldn't say the word "sell."

His sorry record? In January 2001, of 107 Internet stocks Blodgett had touted, only one had gone up. One! The second-best stock in the bunch was down 30 percent. As one wag put it, "An orangutan throwing a dart at a stock page would have done far better."

At the time he still wouldn't issue a sell order on any of them. The closest he came was a "near-term neutral" call on eToys just prior to its total collapse into penny stock status. Blodgett is hardly the only offender. There is a general tendency in Wall Street analyst circles to disdain the "S" word.

Morgan Stanley Dean Witter analyst Mary Meeker, who pulled in US$15 million in 2000 as an Internet guru, remained bullish in January 2001 despite her 11 Internet stock recommendations being down an average of 83 percent from their highs.

But it's not just Internet stocks. Analysts and brokers tend to be biased against selling. Why? Because recommending selling is tantamount to admitting you made a mistake recommending the stock in the first place. And so analyst brokers have developed a whole lexicon of buzzwords that mean "sell", even though they seemingly mean something else.

In his book *It's When You Sell That Counts*, Donald Cassidy, a senior analyst with Lipper Analytical Services, says that all of the following analyst buzzwords should be interpreted as "sell."

- Hold
- Accumulate
- Long-Term Buy
- Market Performer

- Market Weight
- Perform in Line
- Underperform
- Underweight

And the most dangerous word here, he argues, is *hold*. "In fact, *hold,"* he says, "really should generally be interpreted as meaning *do not hold.*"

This interpretation is used by Mark Hulbert in his analysis of market newsletters. The *Hulbert Financial Digest* tries to rate and compare an extensive collection of investment newsletters applying uniform criteria to each. One of these criteria is that *hold* be interpreted as *sell*.

This has ruffled the feathers of some newsletter writers like James Dines, who still likes to write nasty remarks about Hulbert periodically in *The Dines Letter*. But as Hulbert explains his rationale, when managing a newsletter's recommended portfolio, he does not sell into a vacuum. He uses the proceeds from the sold "hold" stock to purchase stocks the newsletter writer rates as "buy". Surely a "buy" recommendation is stronger than a "hold" recommendation and the newsletter writer expects the "buy" recommendation to perform better than the "hold" recommendation, otherwise he would maintain a "buy" recommendation on the stock.

So we have another stock selling strategy - sell when brokers and analysts downgrade their recommendations to one of their euphemisms for "sell".

You should be cautious when a stock is downgraded even if a buzzword for "sell" is not used. A downgrade from strong buy to buy, or from top pick to outperform, or a cut in the target price, still seems to be a positive recommendation. But it is also a downgrade, which does not bode well for the stock. Such a stock should be monitored for further downgrades if not sold right away.

Downside to Selling on Broker/Analyst Euphemisms for Sell

The big hazard to selling on a broker/analyst downgrade is that the broker/analyst could be wrong. As our examples of Blodget and Meeker above show, they often are - and in spades. So they could just as easily err on the downside as the upside. Nevertheless, given the industry reluctance to issue a sell recommendation, a sell euphemism is a fairly strong indicator that they are reluctantly backtracking or have knowledge that there is a serious problem.

Summary of Advantages and Disadvantages of Selling on Faltering Fundamentals

Advantages	Disadvantages
Avoid a disastrous rout	Analyst could be wrong

Note: Parts of this section were reprinted from my book, The 50 Best Science & Technology Stocks for Canadians: 2003 Edition

8 – It's When You Sell That Counts
A Review of the book by Donald L. Cassidy

"It ain't over 'til the fat lady sings!" goes the old baseball saying. The market version says "It ain't a profit until you sell!" And while much is written on stock selection, precious little is written on selling. Donald L. Cassidy, senior analyst with Lipper Analytical Services, sets out to remedy this neglect with this fine book.

The mantra from most circles is "buy and hold for the long term". Tell that to the folks who bought Nortel at $120 - a price level it may not see again for many years. Or late buyers of Amazon.com or Yahoo or countless other new economy stocks. The blunt fact is that markets have their ups and downs. Individual stocks are even more prone to wide fluctuations. And without a selling plan, all your paper profits could well go up in smoke, as they did for many investors since March 2000.

In a chapter called "Rethink That Old Buy-and-Hold Religion," Cassidy argues that the bias towards buy-and-hold is based on the long term bull market we've had since 1982. Most of today's young analysts and fund managers had not seen a long two-year bear market. They didn't experience the 1973-74 or 1977-78 slumps, let alone the massacre of 1929.

Students of market history know that it took until 1954 for the Dow Jones Industrial Average to recoup its top in 1929. The Japanese Nikkei is still trading at less than half its 1989 peak and is once again approaching the low set in 1995. Many think it may be years before the NASDAQ recovers its former highs.

As Cassidy points out, fundamentals drive stock values, and fundamentals change. The buy-and-hold philosophy assumes that a company that has historically grown will continue to do so. It also assumes that the company's growth rate will remain constant. And thirdly, it assumes negligible fluctuations in interest rates with negligible recessions. "Brave suppositions indeed!" he avers.

He points out that even such a stalwart blue chip as IBM at one point suffered a 75% drop in price. And Big Blue was lucky. It is the only survivor of the seven largest computer manufacturers of 1984. Other former market leaders - Apple Computer, K-Mart, Levitz Furniture, Polaroid and Winnebago among others - suffered similar fates.

Clearly Cassidy thinks a buy-and-hold approach is similar to being an ostrich with your head in the sand. He believes a pro-active approach to investing is far sounder.

Psychological Barriers to Selling

The book is divided into four sections, each looking at a different part of the selling puzzle. The first section - Roadblocks to Profitable Selling - looks at institutional and psychological roadblocks. These include the reluctance of broker analysts to issue sell recommendations, an institutional bias towards buy-and-hold, comfort zones, commission phobia and other rationalizations.

These factors are expanded on in the second section - Developing the Proper Mindset for Profitable Sales. The successful investor must learn to acknowledge mistakes, take his lumps and move on. He must also learn to recognize and avoid being drawn

into the psychology of the crowd. The investor must think independently. Cassidy explains how to turn denial into action.

Perhaps one of the best insights that Cassidy offers is that "the hold decision ought to *be* a decision." It should be an active choice, not a passive product of neglect. It is the equivalent of buying a stock now without the commission. Your holdings should be regularly reviewed with this in mind.

Other suggestions - forget your cost price and separate the stock from the company. Yes, it may be a fine company but what is the stock doing?

Cassidy goes on with a section on "Mastering the Contrarian Approach." The essence of this approach is to buy when everyone else is selling and sell when everyone else is buying. He discusses the telltale signs of an over-exuberant market - many of which were evident at the peak of the NASDAQ and Internet boom. Stock market news on the front pages of the newspaper. People talking about stocks over lunch more than usual. Numerous IPOs, many doubling or more immediately. General bullishness. The expectation of historically unrealistic returns. The downplaying of risk. And so on.

Cassidy spends considerable time discussing such psychological issues as emotions, self-discipline, and greed. "Sell when it just feels so good!" he says.

Selling Tactics

Cassidy concludes with a section on selling tactics. He goes into some detail discussing market stocks versus loner stocks, above-market orders as an alternative to stop-loss, the different approach to take with penny stocks, interpreting the significance of good and bad news and what to do in a crash.

He concludes with a Hold-Versus-Sell Decision Check List. Twenty questions focus your attention on the stock at hand to help you decide whether or not to sell. The first five are asked at the time of purchase - date, price paid, price target, target date, and why the stock is expected to go up. The rest of the questions, such as "Are you currently more, less, or equally excited and sure about the company versus when stock was first bought?" help to focus on the current status of the stock. Most have to do with re-appraising the stock in light of the assumptions made when the stock was bought.

But the ultimate test is this - would you buy the stock today? Cassidy phrases it even more persuasively calling it the "Mother Test". Would you recommend the stock now to your dear old gray-haired momma?

"Your mother might forgive you an error, but you will still feel bad for having made it," says Cassidy. So "treat yourself as well as you would hope to treat Mom!" Touché!

This review necessarily only gives an overview of the valuable insights offered by this excellent book. It contains much more depth than I can give justice to in such a short space.

If you're one of the many people who made great paper profits in the first quarter of 2000 only to watch them dwindle away to nothing or a loss, you need to read this book! If you lost money on Nortel, you need to read this book! In fact, all investors can profit from Donald Cassidy's insights into stock selling strategies.

About the Author

Marco den Ouden was the Guide to Investing: Canada at the About.com topical site from 1997 to 2001. He aggregated and annotated net links of interest on the topic as well as wrote weekly feature articles for the site. Rob Carrick of the Globe and Mail included it as one of his 50 Essential Financial Websites for Canadians in his book *The Online Investor's Companion*. "Investing: Canada is a must-see resource for investors looking for a Canadian slant on all things financial," he wrote.

Marco is also the author of two books – The 50 Best Science and Technology Stocks for Canadians: 2002 Edition and also the 2003 Edition. Ace newsletter write Pat McKeough (*The Successful Investor*) said of the book: "Marco den Ouden has done a great job of singling out potential winners in this volatile, pitfall-ridden market segment. To top things off, the book is an easy and enjoyable read. Highly recommended."

In January 2002 Marco launched his independent website The Break Out Report (http://breakoutreport.com) and in November that year he partnered with Ken Ballard, an independent business consultant and co-presenter of the Raymond Aaron Monthly Mentor program, to launch a subscription newsletter version of The Break Out Report. For more information, visit our website.

Marco is married with two teen-age children and lives in Maple Ridge, British Columbia.