FUNDAMENTALLY

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Buying Is a Snap. Knowing When to Sell Is Tough.

CONTRARY to popular belief, many investors did not lose money in the Internet meltdown because they had jumped into bed with high-risk stocks. It was because they had done so without figuring out how to end those relationships down the road.

That may sound unromantic, but investors need to be cold-hearted. Not having a sound "sell" strategy — or any exit plan, for that matter — was a big mistake for many people when the stock bubble burst and paper profits turned into huge losses. Investors need to take that lesson to heart, because the Nasdaq has entered what is starting to look like an all-too-familiar place.

After a strong rally last year, the Nasdaq composite index is in a correction. While it is too soon to predict a rerun of the 2000 market, which wiped out most of the gains of 1999, the Nasdaq has lost nearly 8 percent of its value since its January peak.

Even if history is repeating itself, this is no time to panic. In fact, times like these call for a rational investment approach that includes a disciplined plan for cutting one's losses. At least that is one way to interpret a new study of institutional money managers.

In the study, published this spring in The Journal of Portfolio Management, Christophe Faugere, Hany A. Shawky, and David M. Smith — finance professors at the State University of New York at Albany — examined the performance of money managers who oversee pension funds, endowments and high-net-worth accounts. Because institutional money managers often work under highly defined trading rules, the three professors were able to analyze these investors' performance based on their specific approaches to selling stocks.

The professors determined that during the bear market months from April 2000 to December 2002, investors who fared the best — relative to their market benchmarks, at least — were those with restrictive rules that did not allow much leeway for hanging onto stocks for emotional reasons.

For instance, more than a third of the 4,332 institutional money managers in the study relied primarily on a strategy called "valuation level" selling. That is a fancy way of saying that they sold stocks because they became too pricey, based on measures like earnings or book value.

Investor ruthlessness may help avoid a broken heart.

The study's authors regard such a strategy as highly disciplined and objective. Managers who relied on this method outperformed their chosen benchmarks by 0.46 percentage points a month or 5.5 points a year, on average, during this period.

By comparison, institutional managers who relied on more flexible sell strategies — requiring judgment calls on the health of a business — fared worse. They beat their benchmarks by just 0.08 percentage points a month or just less than 1 point a year, on average, during the downturn, despite outperforming the more disciplined sellers during the roaring bull market of the late 1990's.

What does this mean for investors who may not have the skills or the resources of professional money managers?

For starters, it is a reminder that some kind of selling discipline is better than none. "Without any kind of strategy, emotions will come into play and emotions are almost always wrong," said Greg Forsythe, director of the equity model development team at Charles Schwab.

Beyond that, said Mr. Shawky, director of SUNY's Center for Institutional Investment Management, "discipline matters in down markets."

The notion of cutting losses may seem anathema in the world of long-term, buy-and-hold investing. But it makes sense to hold all your stocks forever only if every one of your "buy" decisions is perfect. And who can claim that?

That is why it is important for investors to introduce discipline and structure to their investment plans. Here, we can take cues from some mutual fund managers:

SET TARGET PRICES Like many managers, Lanny Thorndike, lead manager of the **Century Small Cap Select** fund, judges how high each of his holdings may trade over the coming 12 months. This target is based in part on his judgment of how much others are willing to pay.

Whenever a stock comes within 5 percent of his target price, Mr. Thorndike trims his position. In the first quarter, he sold shares of **Sunrise Senior Living,** the assisted-care company, as its price approached his target of $42. The stock fell to $30 a share in early May. He bought its stock again at $33; It now trades at $36.04. "The sell discipline deserves more credit than the analysts or myself when it comes to keeping us out of trouble," he said.

SET A FLOOR "The key to good investment results is to avoid the big loss," says Arieh Coll, manager of the **Eaton Vance Growth** fund.

Academic research tells us that individual investors have a knack for hanging onto money-losing stocks. But one way that Mr. Coll makes sure that he does not ride his losers all the way down is by re-examining any holding that falls 15 percent below its recent peak. Although some managers sell at this point, using what are called stop loss orders, Mr. Coll reassesses his entire investment: he decides whether to dump the holding and take advantage of the tax loss, which he can use to offset other gains; to stand pat; or to buy more shares.

This forces him to deal with his laggards head-on, instead of avoiding the topic, as many investors do.

MAINTAIN DIVERSIFICATION CAPS Investors often benefit from cutting their losses and keeping their winners, but there are limits to the strategy. For example, if you let your winners grow too big, a diversified portfolio can quickly become too concentrated in a handful of stocks, raising the risk level.

The managers of the **Jensen Fund** have a simple way of dealing with this. Whenever a stock in the $2.2 billion fund becomes more than 7.5 percent of the overall portfolio, the holding is trimmed, said Robert G. Millen, the fund's co-manager.

This approach keeps any single stock from having undue influence over the entire portfolio, and ensures that you take some profits along the way.

MAKE YOUR SELL STRATEGY WORK WITH YOUR BUY DISCIPLINE Whatever your approach, your sell discipline should reflect your buy strategy. Consider the Jensen Fund again. The only stocks that qualify for this large-cap growth portfolio are of companies that have produced returns on equity of 15 percent or more for 10 years in a row. Only about 120 companies in a universe of 10,000 meet that standard, Mr. Millen said.

If a holding stumbles and breaks its string, it is kicked to the curb. That happened with **Intel** in the spring of 2001. The fund sold out of its position at about $31 a share, Mr. Millen said. By the summer of 2002, the stock sank as low as $15.

"Our preferred holding period for all our stocks is forever," he said. "But in the real world, we know that doesn't happen." □

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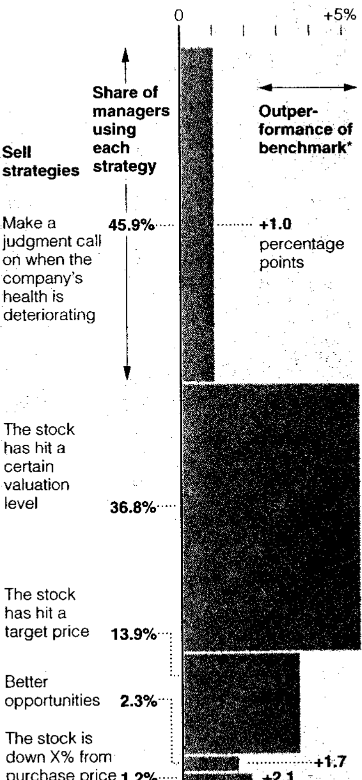
When to Sell

Here are the primary stock-selling strategies used by institutional money managers during the bear market period of April 2000 to December 2002.



*The average annualized outperformance of portfolios, compared with managers' chosen benchmarks, generally stock indexes.

Source: The Journal of Portfolio Management

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