

CONSULTANT'S CORNER



E. JEFFREY ROOF

Investment plan helps determine sell points

In managing an investment portfolio, the decision to sell a particular security or mutual fund is just as important as the decision to buy. However, for many investors, establishing a framework for deciding why, when, and how to sell an investment is often overlooked.

When approached in this manner, sell decisions can be knee-jerk reactions that are often made for the wrong reasons. Likewise, a decision to sell might never be made at all, and a portfolio's performance ultimately suffers.

The sell side of the investment equation is often ignored for many reasons. Some of these include the fact that the financial services industry encourages investors to "accumulate", which typically means, "buy my fund". Even the premise of dollar cost averaging emphasizes that you'll be able to buy more shares per dollar of an investment as the price of that investment goes down.

Likewise, investors are typically solicited with reasons to buy a particular security, as opposed to reasons to sell an existing holding. And once purchased, it is not unusual for investors to commit the mental mistake of becoming an ardent fan of their particular investment.

Am I suggesting aggressively trading your portfolio in an attempt to time either the market as a whole or the highest price of a particular position? Absolutely not. Neither

has proven to be effective for any significant period of time. But somewhere between the absurdity of day-trading and the passiveness of inactive management is a disciplined sales decision matrix that will help you better meet your long-term investment goals.

Since all portfolios and their accompanying objectives are unique to that investor, it is impossible to generically address "what" investment might need to be sold in a particular portfolio without thorough review. However, your ability to determine "what" is greatly improved if a defined investment policy is in place and provides some benchmarks to monitor the "why" and "when" of your portfolio sell decisions.

Listed below are four considerations in each of these two categories that can be used as part of a disciplined and proactive sell decision framework.

Why might investors want to sell a particular fund or security?

- *To maintain portfolio diversification and preserve a defined asset allocation.*

Assuming your portfolio is somewhat diversified and was structured with a target asset allocation in mind, changes in the valuation of your investments will obviously impact those allocation percentages. The benefit derived from whatever allocation is appropriate for your situation diminishes dramatically if that allocation is not periodically adjusted to target levels. That adjustment, or rebalancing, will typically require the sale of securities.

- *To capture gains or protect losses.*

If an investment has appreciated significantly, a sale decision may be made to capture some of the previously unrealized gains. This can be a very appropriate for a wide variety of reasons.

Likewise, protecting a specific investment from ongoing depreciation may be another reason to consider liquidating all or part of that position. Though this may appear to be a rather obvious tactic in theory, it is often used somewhat ineffectively because decisions are made without clear points of reference. More on that later.

- *To extract invested principle.*

To some investors, recovering the original amount of money invested in an appreciated fund or security can be a motivator for a sale decision. For example, an investor who holds \$50,000 of ABC Corp might decide to recover the original investment of \$20,000 by selling an equivalent portion of his or her current position. Conceptually, the principal is now returned and the investor is using those dollars for other purposes.

- *To minimize tax consequences.*

For an investor realizing significant taxable investment gains in a particular year, selling some poorer performing holdings before year end might be useful in offsetting some of the realized taxable gain. Obviously this strategy is only of benefit in accounts that are currently taxable, not individual retirement accounts or other retirement plans.

When might investors want to sell a particular fund or security?

- *When your portfolio's allocation needs adjustment.*

If you are attempting to preserve your portfolio's diversification through periodically monitoring your asset allocation, determining when you rebalance is important. Too frequent an adjustment period could have decisions being made on short-term pricing fluctuations and increase portfolio management costs.

While some proponents of the process suggest an ongoing monthly readjustment, in most situations a periodic quarterly rebalancing is sufficient unless other circumstances accelerate the need to adjust portfolio weightings.

- *When your target prices are reached.*

Setting high and low target prices for each asset in your portfolio can add clearly defined parameters to your sell decision framework. The price levels that will potentially trigger a sale are predetermined based on your expectation and can provide a clear point of reference when assessing whether an investment should be sold.

- *When the fundamentals change.*

Any significant shift in the philosophy, management, industry or business projections of an investment warrants reevaluation as to whether that investment remains appropriate for you to hold. Don't let your original decision or excessive optimism cloud your judgment. Make sure this investment is still complementary to your overall objectives and portfolio structure.

- *When purchasing a new investment.*

It can be useful to evaluate what existing holdings you would need to sell in order to make an investment purchase possible. Though you may actually be using new dollars for the addition, this "investment budgeting" helps maintain a focus on both sides of the investment decision and forces a comparative evaluation.

Outlining the general parameters of why and when you plan to sell is a critical part of successful portfolio management. Defining this framework in advance eliminates much of the emotion from the process, assuring both buying and selling remains focused on the key essentials that contribute toward your long term investment goals.

E. Jeffrey Roof is president of Roof Advisory Group, an independent investment management and financial planning firm based in Camp Hill. The firm is a fee-only Registered Investment Advisor that manages assets and preserves wealth for individual & institutional clientele.