How to Take Your Emotions Out of the Sell Decision

Facing criticism from a colleague over modifications he made in his economic analysis, the famous British economist John Maynard Keynes once said: “When the facts change, I change my mind. What do you do, sir?”

Keynes’ question is a relevant one for investors. Unless you are a buy-and-hold-forever investor, you will frequently be faced with the challenge of changing your mind. A decision to buy a stock will eventually and inevitably be followed by a decision to sell the stock.

And when you decide to sell, you are effectively changing your mind about the prospects of the investment. Unfortunately, however, changing one’s mind is easier said than done. This is particularly true in the world of investments where uncertainty reigns and emotions run high. That combination—uncertainty and emotions—often leads to poor judgment.

In his book “Against the Gods: The Remarkable Story of Risk,” Peter L. Bernstein says that the evidence “reveals repeated patterns of irrationality, inconsistency, and incompetence in the ways human beings arrive at decisions and choices when faced with uncertainty.”

In the academic world, the disciplines of psychology, economics and finance have converged to study this issue, thus creating the field of behavioral finance. Numerous behavioral biases have been identified that inhibit human beings from making wise financial decisions.

When the decision involves changing one’s mind, the emotional biases tend to become even more severe. We perceive that if we make a decision to sell a stock, we will be declaring our previous buy decision to be either a success (selling at a profit) or a failure (selling at a loss). Studies in behavioral finance have shown that our strong desire for success and our even stronger fear of failure can play havoc with our rational perception of the situation.

So it should come as no surprise that investors tend to have more trouble with the sell decision than they do with the buy decision.

For many investors, it is more difficult to know when to sell a stock than it is to know when to buy it.

Well-intended bits of wisdom and rules-of-thumb serve only to confuse the matter:

- Investors are told to “let your winners run,” but are also told that “no one ever went broke taking profits.”

- Investors are told to “cut your losses early,” but are also told to “average in” by buying more stock as the price declines.

Obviously, there is no magic formula to eliminate the uncertainty we face when making sell decisions, but we can do something about the emotional entanglements.

One way to approach the problem is to completely automate the sell decision. Most often, this automation is based on stock price movements alone—for instance, if a stock price declines by, say, 20% it is automatically sold.

Unfortunately, in addition to removing the unwanted emotional entanglements, this approach entirely removes the human element from the decision. For those of us who believe that people make better judgments than computers or mathematical formulas, this approach seems quite extreme.

Improving Judgement

Rather than talk about ways of removing our human judgment, let’s focus on ways of improving our human judgment in the sell decision.

Investing is both an art and a science, and experienced investors learn to take special precautions to prevent emotions from unduly influencing decisions, particularly sell decisions.

For some, a set of principles and procedures helps us in this regard. It is not called a “sell discipline” because that term is overused in the industry and many perceive it to imply the mindless automation described above. Instead, it is called an “accountability system.” It doesn’t automate decisions, but it minimizes emotional influences by holding the human decision-makers accountable to a set of rational criteria.

Importantly, this approach can be applied by anyone. Of course, we each have a style of investing that is unique to us. But this accountability system can be useful regardless of your particular investment style.

Thesis Statement

The process of laying the groundwork for a better sell decision should start even before you buy a stock. In particular, before a stock can be purchased, a thesis statement should be developed that spells out in some detail the reasons you believe it will turn out to be a good investment.

The idea here is that in order to know when to sell a stock, you have to know with a fair amount of specificity why you bought it in the first place.

The more solid this initial foundation, the less you will be affected by the inevitable ebb and flow of the confusing and potentially overwhelming flood of information and opinions surrounding the stock.

Here are some guidelines for developing your thesis statement:

Put It in Writing

The thesis statement must be in writing. This is imperative. Don’t trust your memory. Not only is human memory imperfect, but the confidence we place in our memory can sometimes be disproportionate to the level of its accuracy. In other words, as time passes, the accuracy of our memory fades, but our confidence in what we think we remember can remain high. This is a dangerous combination, and the only way to counter it is with a written record. There is much wisdom to the old saying that “a short pencil is better than a long memory.”

The written thesis statement does not have to be terribly long. This is not a doctoral dissertation to prove your complete knowledge of all facts and figures related to the subject. Rather, this is a recording of the basic tenets supporting your belief that this stock will be a good investment. A few paragraphs can usually suffice. In fact, there is a benefit in keeping it short because it forces you to focus only on what is most important. If you can’t keep it short, it may be because you aren’t really sure what is important.

When Peter Lynch was managing the Magellan Fund, he used to impose a three-minute rule on his analysts for this reason. If they couldn’t adequately explain the thesis for owning a stock in less than three minutes, they wouldn’t invest in it.

Decide What Would Make You Sell Before You Buy

The time of purchase is the very best time to establish sell criteria, and you should include this is your thesis statement. The reason is that the emotional distractions are at their lowest point. Your judgment is not influenced by feelings of success or regret because you have experienced neither.

Of course, unless you are clairvoyant (in which case you don’t need a sell discipline anyway), it would be impractical to come up with an exhaustive list of every event that could possibly make you decide to sell the stock. Detail and precision is not the goal here. Rather, the idea is to think through several plausible scenarios, including positive developments (the price target at which you would sell, for example), as well as negative developments (the business loses a key competitive advantage, for example).

Sell criteria should be the inverse of buy criteria. Any other reason for selling (or choosing not to sell) a stock would be inconsistent with your investment philosophy. So, for example, buying a stock because you like the company's growth characteristics, but choosing to hold on to it in the face of slowing growth simply because it has become cheap, is an inconsistency.

Another example of inconsistency would be a value investor who attempts to "ride the momentum" of stocks long after they have become overvalued. Decide which reasons convince you to buy a stock, invert that reasoning, and you have a pretty good set of sell criteria.

Quantify Your Expectations

If emotion is to be limited, objectivity is the goal. Objectivity requires quantities that can be measured, but we live in a subjective world and the "qualities" we look for in an investment are not always easily "quantifiable." This quality vs. quantity conundrum can be difficult to deal with, but that shouldn't stop you from trying. Some quantification is better than none.

Think through the thesis. If it plays out as you expect, what measurable results should you expect to see? What will be the most important? It will not be the same for every company. Sales growth may be a key driver for a retailer, margin expansion may be more important for a manufacturer, asset quality may be key to an investment in a finance company, or working capital management may be crucial for a distributor. The goal is not uniformity across all companies in the portfolio, nor is the goal to identify an exhaustive list. Rather, the goal is to identify the measures most likely to reflect the success or failure of the thesis over time. In fact, part of the value of the exercise is the process of deciding which few variables are the most crucial. I suggest no more than three or four variables for each company.

Don't Go It Alone

Studies have shown that, except in rare instances (such as highly complex projects requiring specialized expertise from multiple disciplines), a committee is generally not the best forum for optimizing decision-making. But neither is an individual operating autonomously. Rather, the best decision-maker is an individual who has wise counsel from well-informed advisers. The interaction with advisers plays a critical role in avoiding emotional entanglements. Advisers can be more objective because they do not bear the weight of the responsibility for the decision, thus their own personal success or failure does not hang in the balance.

For an individual investor, a group of friends or an investment club can provide the same benefits as a formal investment committee, but it is important to make the meetings at least a little bit challenging. When buying a stock, share with the group your thesis statement and your sell criteria, then ask them to hold you accountable to that criteria over time.

Measure the Progress

Every quarter (or however often new data becomes available), the company's actual performance on the key variables should be compared to the expected levels. Discrepancies should be noted. Large or persistent discrepancies should be a cause for concern and should trigger a complete review of the thesis.

Review the Thesis Regularly—If the Facts Change, Change Your Mind

The thesis behind each stock you own should be reviewed whenever a company announces earnings or releases significant data—for example, at least quarterly. Again, the goal is not a comprehensive rundown of every detail about the quarter but, rather, a review of how the original thesis is progressing.

Is the original thesis intact, or not?

That is the key question. If the answer is yes, you should hold on to the stock. If the answer is no, then the facts have changed and John Maynard Keynes would suggest that it is time to change your mind.

The important point about this whole process is that it has finally forced you to this question, and you are making your decision based on the key facts and not the confusing ebb and flow of information and opinions I referred to earlier.

Facing the Facts

It is no sin to be human. Unless you are a die-hard quantitative investor, you must believe that at least some human judgment in the investment process is a good thing. But studies in behavioral finance demonstrate that human emotion can play havoc with our judgment. Pure, undisciplined human judgment will lead to poor sell decisions, but so will mindless, robotic decision rules. Optimization lies somewhere in between. The system we've outlined disciplines human judgment without removing it. Keep in mind that there are probably other successful systems, but this one can work for just about anyone.

> This post was adapted from Jim Norris' **article**, which originally appeared in the August 2002 issue of the *AAII Journal*.