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MARKET MATTERS: Letting go … for now

By Joseph Matthews
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Joseph Matthews

Everyone knows the old adage about letting go of something you love and seeing if it comes back to you. In the case of investing, sometimes letting go of a stock you love — or loved when you bought it — is the right thing to do.

The problematic part of the adage, for investors, is the emotion “love.” In fact, when it comes to investing, all emotions — including love, fear and greed — can be problematic. Investing should be devoid of emotion entirely.

Managing our finances without emotion is easier said than done. Unlike animals, who are driven by instinct, as humans, we investors have emotions that try to dictate our behaviors. In fact, “behavioral finance” seeks to study why people make certain financial choices.

One interesting quirk observed in behavioral finance is known as the “disposition effect”: the tendency to sell assets that have increased in value, and to hold on to assets that have decreased in value.

Why would we do that? Psychologists found that people hate losing more than they relish winning. Perhaps it’s the fear of “looking dumb” for having made a mistake by buying the stock in the first place. We hang on instead of letting go. The problem is

magnified when we hold on to losing positions for too long, compounding our losses as prices drop further.

It’s easy in hindsight to understand why. Downward slides in stock prices, such as those seen in the dot-com bubble of a few years ago, may show temporary reversals — slight upticks in value known as a “dead cat bounce” — followed by a continued plummet. That uptick gives us hope that a stock will recover, when in fact it won’t.

Recognizing when to sell a stock is tricky. If a company remains solid, the decrease in stock price actually may present an opportunity to acquire more of it.

Reversely, it may be necessary to sell a stock that has risen in price. Often, we buy a stock with the vague goal in mind of selling it after it has grown by a certain percentage … and when it does hit that magic number, we greedily wait for it to grow some more. The danger is the stock dropping precipitously from its peak — meaning not only do we miss out on potential profit, we may actually incur a loss.

Selling stocks when emotions are high goes hand in hand with selling when sudden need arises. Had we planned carefully in advance, we might have constructed a portfolio that worked to meet our goals and milestones, based on a thoughtful timeline.

Thus, the move to a bigger house, the arrival of a new baby or the purchase of a vacation home would be previously mapped and planned for, negating the unnecessary or impulsive selling of an asset to finance an event.

The decision to sell should be based on the inherent value of the stock, not on its holder’s financial situation.

In investing, fear might be the most detrimental emotion of all. Panicked selling of a stock as a response to gyrations of the market is almost never a good thing. Don’t make investment decisions based on unnerving headlines or the actions of a crowd. Make them, instead, based on your unique life goals and overall strategy for wealth management.

Letting go of something we love is hard. Letting go without emotion is easier. Keep emotions at bay, and the rewards of levelheaded investing may very well come back to us in the end.

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