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STOCKS

Behavioral Challenges of Sell Decisions

Greg Forsythe, CFA, Senior Vice President, Schwab Equity Ratings®, discusses why it's so hard to decide when to sell a stock.

When speaking to investor groups, I often ask the question, "Who believes it is more difficult to decide when to sell a stock than when to buy one?" Inevitably, nearly everyone raises a hand and most faces display a knowing smile or look of pain. Why is it so difficult to decide when to sell? The field of behavioral finance offers useful perspective into the psychology of investing and why sell decisions are particularly challenging.

Loss Aversion

Investors intuitively understand that potential return and risk are closely related. The potential for higher returns is necessary to lure investors to buy risky stocks versus holding low-risk investments such as Treasury bills. But psychologists have found that investors aren't simply risk averse; they're strongly loss averse. The pain of loss has about two times the intensity as the pleasure of gain. I believe many investment decision-making mistakes stem from this **loss-aversion** phenomenon.

Biases When Buying

Since losses are so painful, we must feel optimistic about an opportunity before putting our money at risk. But the need for optimism can lead us to trouble. For example, we're often drawn to stocks perceived as having outsize potential for gains, such as technology-related initial public offerings. That potential large gains weigh more heavily in our minds than the low probability that these gains might occur is a bias called the lottery effect. Investment bankers feed the flames of optimism with proclamations like "Groupon is the next Amazon!" These analogies exploit the **representative bias**—our tendency to assume similar appearances will lead to similar outcomes.

To avoid mistakes, thoughtful investors attempt to thoroughly research new ideas, but in doing so they can become vulnerable. The **availability bias** is the tendency to make decisions based on easily accessible information, not necessarily on what's most important. Investors can also fall victim to the **illusion of knowledge**, the belief that more knowledge necessarily leads to better decisions.

Since we need to feel confident before acting, when we buy a stock we often become not only financially invested, but also psychologically invested. As a result, reversing that decision—deciding to sell a stock—becomes more difficult than it should be.

Ownership Creates Issues

In the world of investing, ownership exposes us to a whole new set of biases:

- The **endowment effect:** The tendency to place a higher value on things we own than others would.
- **Confirmation bias:** When we look for information that supports our ownership decision and discount conflicting information.
- **Status quo bias:** The tendency to strongly prefer to sit pat with what we own over buying more or discarding it.

These biases conspire to make us less likely to interpret new information as a reason to sell.

Anchoring on Purchase Price

The moment we purchase a stock, a new data point—purchase price—is created. Because purchase price determines our gains and losses, it becomes an important reference point that leads to the **disposition effect**, the tendency for investors

to sell winners too soon and hang on to losers too long. Because we're loss averse and wish to avoid the pain of regret, we often hold on to losers hoping a rebound might get us back to break even. For the same reasons, we're quick to take profits on winners, as we fear a sudden price drop might turn a winner into a loser. These decisions are costly. Researchers have found that the stocks investors sell significantly outperform the stocks they buy over the following year.

Being influenced by an irrelevant figure is called **anchoring**. Investor fixation on cost basis is a particularly insidious form of anchoring because it hardly seems irrelevant at first thought. But we forget that our cost basis is unknown to the market and has absolutely nothing to do with the future prospects for any stock we own. Except for tax reasons, cost basis should never factor into your decision to hold or sell a stock.

Rules as a Remedy

Most investors make similar decision-making errors when the fear of loss activates their emotions—a common condition when deciding whether to sell a stock. Fortunately, since behavioral mistakes fall into regular patterns, decision-making rules can help temper our counterproductive tendencies. For tips on how to avoid such behaviors, see "Stock Buying Dos and Don'ts" at right. ■

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To research the right stocks for you, log in to **schwab.com/stocks** (Schwab Equity Ratings).

Stock Buying Dos and Don'ts

1. **Develop a strategy that clearly identifies the characteristics of stocks you will purchase.** Employ tools such as Schwab's Stock Screener, Stocks Lists and Schwab Equity Ratings to find stocks that meet your purchase criteria.

2. **Don't insist that everyone rate your stock as a "buy." Avoid "story stocks."** Don't listen to unsolicited ideas from unknown or unproven sources.

3. **Before buying a stock, write down the reason(s) you like it and list what future occurrences would make you want to sell.** Expect that half of your purchases will not perform as you hope and that many may go down in price.

4. **If you're a long-term investor, check in on your portfolio no more than weekly or monthly.** Focus on your overall portfolio's performance against a benchmark. Try to ignore your cost basis and the gain or loss on every stock you own.

5. **Regularly evaluate each stock against your predefined sell rule.** If it violates your rule, sell it regardless of current or purchase price. Consider using Schwab Equity Ratings as an objective tool. Strongly consider selling stocks rated D or F (and lower-rated Cs if you're more aggressive) and replacing them with A-rated stocks.

6. **Don't sell a stock just because it has gone up or down in price.** Consider using a stop-loss rule (e.g., sell if price drops 20%) if you just can't take holding a big loser that hasn't triggered your primary sell rule.

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