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5 Scenarios When Selling Stocks Makes Sense

Hint: It has nothing to do with the market, and everything to do with your personal circumstances.

Ask legendary investor John Rogers Jr. about his biggest challenges, and the story he tells is about selling stocks, not buying them. The chief executive of Ariel Investments earned huge profits on newspaper stocks in the 1990s, and by the mid 2000s Ariel had become the largest shareholder in McClatchy Corp., owner of the Miami Herald and the Sacramento Bee. Even as warning signs mounted—the company carried high debt levels and profits were declining—Rogers held on, hoping for a turnaround. But the stock plunged, and in 2009 Rogers's Chicago-based fund company sold McClatchy shares for just pennies on the dollar. "We drank the Kool-Aid," he says. He adds, "Selling is far more difficult than buying."

A host of psychological factors—from falling in love with an investment to having difficulty realizing a loss—work against those who hope to sell as sagely as they buy. Ariel Investments, says Rogers, now has multiple "triggers" that require stock sales—no excuses, no appeals. He attributes at least part of the improved performance of his company's funds since the end of the 2007–09 bear market to the company's increasingly disciplined approach to selling.

Individual investors would be wise to take note. Whether you invest in individual stocks or through mutual funds, wise investing requires selling and reinvesting your proceeds at regular intervals. This isn't a matter of timing the market. It's more about responding to changes in your life and your portfolio. For most people, savvy selling has little to do with stock prices. Rather, it's a way to maintain the balance of assets in a portfolio, account for a major life change, pay for a goal or reduce risk. (See guidance on when to sell individual stocks and funds, along with specific suggestions for what to dump; also see ideas on where to reinvest your proceeds without resorting to stocks.)

Those who apply a disciplined approach to selling can not only improve their investment performance but also avoid letting a market debacle wreak havoc on their personal goals. The key is to have a plan, says Donna Skeels Cygan, a certified financial planner and author of The Joy of Financial Security. Then, whether the stock market plunges or soars, you can adjust your portfolio without making an impulsive decision. "It's a matter of reminding ourselves what the money is invested for," she says.

A typical financial plan, for instance, might put 60% of assets in stocks and 40% in bonds. The stock portion of that portfolio would be diversified further to hold, say, 25% in foreign stocks, 40% in big-company U.S. stocks, 20% in small-company domestic stocks and 15% in shares of real estate investment trusts (see 5 REITs Making a Comeback).

Likewise, the bond holdings might be divvied up among corporate, Treasury and foreign issues. The right mix of investments will vary based on the age and goals of the investor, as well as on his or her feelings about risk. However, once a good mix is established, it's smart to make sure it sticks.

Scenario 1

The stock market's way up, and bonds are down. Your carefully chosen mix is now out of whack. You need to rebalance.

It's not easy to keep your ideal asset mix constant over time. That's simply because different investments appreciate and depreciate at different speeds and different times. Let's assume you started 2013 with a $100,000 portfolio and wanted that mix of 60% stocks, 40% bonds. Last year, Standard & Poor's 500-stock index, a broad measure of the market, soared 32%, and bond values (as represented by the Barclays Aggregate Bond index) fell 2%. At the end of the year, your portfolio would have grown to $118,400, with $79,200 in stocks and $39,200 in bonds, giving you a mix of 67% in stocks and 33% in bonds. (To keep things simple, we assume the money was invested in those indexes.)

The rational move is to sell $8,000 in stocks and reinvest the proceeds in bonds. A study of investment returns from 1970 through 2013 found that a rebalanced portfolio boosted returns by an average of 0.6 percentage point each year. Starting with just $10,000, a rebalanced portfolio would allow an investor to pocket $157,000 more over a 44-year period, according to research by Exencial Wealth Management. The precise advantage of rebalancing varies based on the targeted asset mix, but the strategy consistently beats portfolios that are not rebalanced for a simple reason: Investment results "revert to the mean" over long stretches. Translation: An asset class that has performed far better than its long-term average for a few years is likely to perform worse than the average for a time. Rebalancing allows you to get out while the getting's good.

Of course, the more comfortable, albeit irrational, move is to do the opposite, says Chris Brightman, head of investment management at Research Affiliates, a Newport Beach, Cal., investment firm. Many people want to follow the herd, sticking with investments that they're enthused about (because they're hot!) and selling those that have produced poor recent results. If you want to be smart about rebalancing, you need to be aware that a lot of people act irrationally—at least for a while, Brightman says.

Why? The investors who buy what's hot and sell what's not create short-term momentum that does tend to fuel the investment that has performed well recently, Brightman says. But that phenomenon lasts for months, not years. Still, if you rebalance too frequently, you'll be fighting market momentum and could sacrifice some return. Wait too long, however, and you'll get caught in a reversion to the mean and give up even more.

The bottom line: Rebalance, but not more often than once a year, says Brightman. And it's okay to rebalance less frequently, such as every other year, if the performance of the markets hasn't thrown your investment mix too far off your targets. Because tedious projects like rebalancing are easy to forget, many planners suggest that you set a regular, and memorable, date to do it. Make it your birthday. New Year's Day. Tax day. Your anniversary. The day on the calendar doesn't matter. What matters is that you establish a routine and follow it.

Scenario 2

You moved, had a baby, lost a job or got divorced. You need to beef up emergency savings.

Although your investment strategy shouldn't shift in reaction to a move in the market, it should react to major changes in your life. That's because marriage, divorce, births, deaths and even significant geographic moves can change your budget and your ability to tolerate risk. If those factors change, so should your investments. "Any major life event should spur a review of your investment plan," says Cygan. "It may only require tweaks or it could require real change. It really depends on the event and you."

Consider, for instance, a dual-income couple who keep three months' worth of their living expenses in savings accounts to handle potential emergencies. Although that's on the low end of the recommended range, it's enough if both spouses have steady jobs and health insurance. That's because the biggest risk is a job loss, but the chance of both spouses losing jobs at the same time is slim. A single job loss might require tapping less than half a month's savings (one spouse's contribution to living expenses, minus the percentage of income he or she is saving each month) for each month of unemployment.

However, if a spouse dies or the couple divorces, the need for emergency savings could skyrocket. A single person should have enough emergency cash to cover twice as many months of potential job loss. So a suddenly single individual may want to boost dramatically the percentage of his or her assets in safe, albeit low-yielding, accounts.

It's not necessary, or even advisable, to move investments quickly in the wake of a major life upset. The best strategy here is to step back and carefully review your financial plan and goals from start to finish. Assuming the life change doesn't alter the big picture, an investor might simply trim volatile stock holdings over the course of a year or two, feeding emergency savings accounts with the proceeds, to better balance the new risks of his or her situation.

Scenario 3

You're finally retiring. You need to replenish the fund you tap for living expenses.

After decades of saving, you got the gold watch. Now what? For starters, a good portion of your monthly paycheck will now come from savings rather than from an employer. This, too, demands selling some stocks, even if you already have five years of spending power in accounts holding bonds and other conservative, fixed-income investments (the standard recommendation). After all, following your first month of retirement, you're likely to have just four years and 11 months' worth of spending power left. Now is the time to strategically whittle back that stock portfolio to replenish the account that you're tapping.

You can make these sell decisions gradually and opportunistically, similar to the way you'd move money into emergency savings in the absence of an immediate emergency. Perhaps when a volatile asset class, such as emerging-markets stocks, has a particularly good year (triggering the need to rebalance anyway), you can sell some of those shares and use the proceeds to cover your spending or feed the fixed account. (The fixed-income account needs replenishing only if you're spending from it.)

What you don't want to do is sell stocks en masse on the eve of retirement, says Stuart Ritter, a certified financial planner with T. Rowe Price, the Baltimore-based mutual fund giant. Remember that a good portion of this money is earmarked for spending in the second half of your retirement, which might be decades away. Although you'll want to have at least five years' worth of living expenses in safe, fixed-income accounts, you'll also need growth investments, such as stocks, to finance your later retirement years. Over long periods, stock returns are far more likely to beat the rate of inflation and allow you to retain buying power. For this reason, Cygan says, she never allows her clients to reduce their stock holdings below 25% to 30% of the overall portfolio.

Scenario 4

You've landed a windfall, struck it rich or saved enough to meet all contingencies. You need to relax about investing.

The most successful (or luckiest) investors can take a cue from the world of sports. Near the end of a football game, when it's clear that the team with the ball has won, the quarterback will often "take a knee." Instead of attempting to rack up more points, the player drops to one knee immediately after the snap, letting the final seconds of the game tick away. After all, the game is won. Why risk fumbling the ball?

Investors in the later stages of their retirement who know they have plenty of money to cover every possible expense can do much the same. And if the volatility of stocks bothers them, they'd be wise to do just that, says Brightman, the Research Affiliates official. "If I can invest very conservatively in a bunch of municipal bonds and live completely comfortably on that income, what would be the point of taking investment risk?" he asks.

To be sure, some investors with more than enough money to sustain them will still choose to invest a meaningful portion of their assets in stocks, figuring that any excess return will help them leave more to their heirs. But at the point that you know you'll have enough money no matter how it's invested, the game is won. You can stop playing. "It becomes a personal decision about whether you want to take risk or not," Brightman says. "Who is to say which is right and which is wrong? It's a personal, emotional decision."

Scenario 5

There's something you want

When you're fortunate enough to have investments that are not earmarked (or needed) for a particular purpose, such as paying for college or financing your retirement, you may want to sell simply because you need the money. Say you need to pay for your child's wedding, a new car or some home improvements. You can finance these purchases with a loan, but if you don't want to add to your debt or if the interest rate is unattractive, selling investments to raise cash can be a good option.

There's a caveat, though. Selling can trigger a tax obligation. If you realize a profit on the sale of an asset in a taxable account, you'll owe tax on the gain at either favorable capital-gains rates (if you owned the asset for more than a year) or regular tax rates (if you owned it for less time). If you cash out investments that were in tax-deferred accounts, such as traditional IRAs and 401(k) plans, you'll owe tax on 100% of what you withdraw—not just the profits—and possibly owe penalties, too.

But judicious selling can help lower your tax bill. If you sell an investment that is in the red, the loss can be used to offset capital gains you realize in the same year; up to $3,000 in excess losses can be used to reduce your regular taxable income. The tax consequences can have a major impact on just how much of your investments you need to sell to cover the cost of your car, trip or high-end kitchen.

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