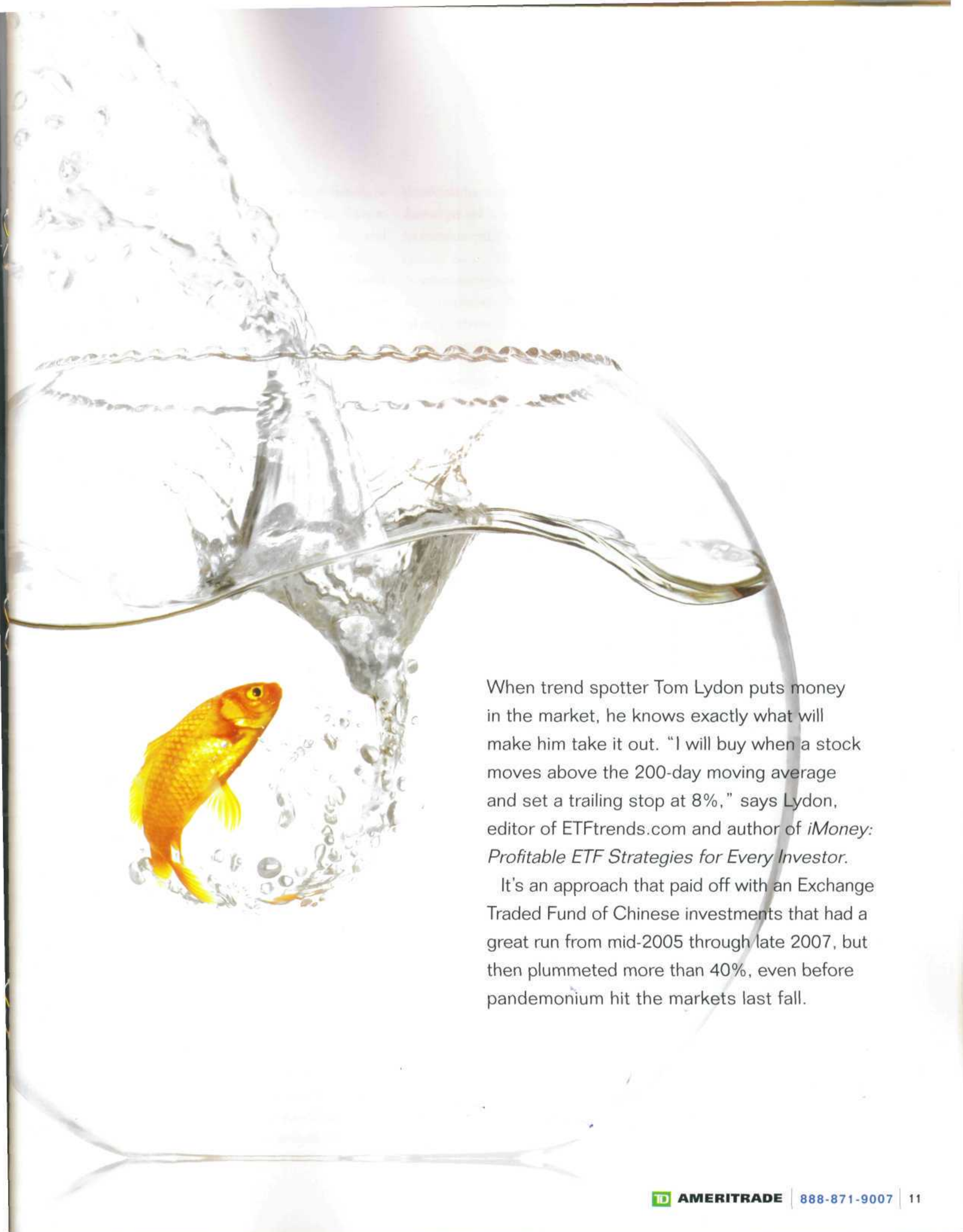
PORTFOLIO ADJUSTMENT | by Eric L. Reiner

Making an Exit

Knowing when to part with an investment may be as important as deciding when to buy



When trend spotter Tom Lydon puts money in the market, he knows exactly what will make him take it out. "I will buy when a stock moves above the 200-day moving average and set a trailing stop at 8%," says Lydon, editor of ETFtrends.com and author of *iMoney: Profitable ETF Strategies for Every Investor*.

It's an approach that paid off with an Exchange Traded Fund of Chinese investments that had a great run from mid-2005 through late 2007, but then plummeted more than 40%, even before pandemonium hit the markets last fall.

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By selling after an 8% slip, Lydon preserved the lion's share of profits in the fund for clients of his registered investment advisory firm, Global Trends Investments in Newport Beach, Calif.

Whether you're an active trader or a long-term investor, it makes sense to have an exit strategy for every portfolio holding, long or short. Ideally, you'll have the plan in place by the time you enter the position. "That allows you

to manage the full life cycle of the trade," says Derek Moore, TD AMERITRADE's Director of National Education. Then, rather than being blindsided by changes in the market or a particular investment, you're in control, booking gains according to predetermined criteria or avoiding deep losses.

A Reason to Say Good-bye

Knowing when and why you'll sell keeps your decisions rational, adds Lydon. "It removes all the guessing, and you aren't left wondering what to do when the markets are moving," he says. That can help regular investors avoid panicked selling at a market bottom, which is just what happened to many investors in early 2003, when they drained money out of mutual funds just as stocks were about to rebound sharply from a harsh bear market.

Holding on too long is another dangerous, emotional response to market events, says Moore. "When an investment moves against them, many people remain hopeful it will get back to break-even, and they do nothing." But if a position has shed half its value, for example, it has to double its price just to take you back to where you started. "It can be very difficult to recover from a large loss," Moore points out.

Conceptually, an exit strategy is really just an extension of your plan for entering a position. You bought for a reason; then, if your investment thesis has run its course or you realize you made a mistake, you sell. Suppose you correctly anticipated that the launch of a product would boost the company's earnings. Once that story has played out, it may be time to move on. Or perhaps the technical signals that led you into a holding have turned negative, such as when Lydon sells an ETF because it has fallen below its 200-day average.

Setting Your Sights

To reap the primary benefits of an exit discipline — avoiding the erosion of your capital and locking in gains — "you generally need exit points on both the upside and the downside," says Moore. Choosing exactly where to set those points depends on your personal investment methodology, tolerance for risk and other criteria.

For the upper limit, a college finance textbook might suggest calculating the price a holding must reach for you to get a predetermined rate of return. For the lower limit, Lydon likes to bid adieu to winners when they drop 8%, because pullbacks as much as 7% are quite common and a stop-loss order for a decline of less than 8% might get you out too soon, before an upward-trending market has reached its peak. "At 8% you might be giving up a little more profit, but it may prevent you from selling prematurely," Lydon says.

Some investors find it psychologically difficult to plan an escape ahead of time, because it suggests they could be wrong about the pick, and that makes them uncomfortable. "People sometimes put pressure on themselves to be right all the time, and they're very reluctant to take even a small loss," Moore says. But even the savviest investors do not make money on every transaction, he notes, and selling when an investment slips can free up the proceeds for what may be a better choice.

One alternative to having a hard-and-fast exit point is to decide you'll take a fresh look at an investment if it swoons a certain amount. "In the institutional marketplace, a rule of thumb is that a 20% drop means it's time to review whether your reasons for entering the stock are still valid," says Stephanie Giroux, TD AMERITRADE's Chief Investment Strategist. If the rationale remains intact, you might even want to add to your position, buying more while shares are a comparative bargain. "But if you don't find a compelling reason to stay, you should sell," Giroux says. "When a holding is down that much, doing nothing is usually not a good option."

Of course, that kind of watchful waiting also means staying on top of what each of your investments is doing, and if the entire market pulls back sharply, as

Ups and Downs

How investment pros decide when to sell. The same approach could work for you

Whether you're an ordinary, everyday investor or a professional money manager, your goal is to minimize risks and maximize gains, which is why the exit strategies developed by Brown Advisory, an independent investment firm in Baltimore, could help you decide when to head for the door. The Brown team won't buy a stock until it has formulated a clear plan for when to sell. "We set upper and lower targets for getting out," says Paul Chew, Research Director at Brown, which oversees $15 billion for individual and institutional clients. "If we're right, we want to know the potential upside. If we're not right, we want to know where things can go wrong, and how badly."

To determine specific exit targets, Chew's team of fundamental analysts builds models projecting a company's earnings and financial condition for three years under a variety of scenarios. Consider an engineering and construction stock one Brown analyst unearthed. "This company attempts to build long-term partnerships with clients so that it won't always have to bid on new jobs," says Chew. That cuts expenses, and when further digging verified the company's success in fostering such relationships, Brown invested. "That was in early 2004, when the stock was in the 20s," says Chew.

The shares performed better than expected, gaining more than 130% in 2007 alone. But rather than simply enjoy the ride, Chew's team continually compared the progress of the company and its stock with the scenarios the group had established before investing. Finally, at the end of 2007, the analysts concluded the shares had become overvalued. "The market had priced in a better case than we thought was possible," Chew says. "So we liquidated the position in early 2008." When Brown sold the shares, they were trading in the high 90s, but by Halloween the price had plunged to the mid-30s.

Other times, of course, investors need to cut their losses, and that can be particularly difficult for those who have banked on beaten-down shares regaining lost market stature. "A lot of value investors are not good sellers," says Bruce Behrens, a value-oriented portfolio manager for Brown Advisory. "To the value investor, stocks that come down in price just look all that more attractive."

To counter that perspective, Behrens relies on "circuit breakers," including such statistical tests as shares dropping excessively relative to the market, or penetrating the downside target the Brown research team establishes before entering the position. When a breaker is tripped, analysts revisit the stock. "Something suggests we might be wrong, so we question the holding to make sure we're not rationalizing away an important problem," Behrens says.

That approach saved clients some misery early in 2008, when circuit breakers went off for two financial holdings. After studying the companies, Behrens reduced his stakes, not long before both firms ran into major trouble. "The reviews protected us from being too sure of ourselves," Behrens says.

That's what an exit strategy is supposed to do — keep investors from becoming overly attached to a stock and failing to let go when it has had its run or fallen too far. Many TD AMERITRADE tools can help you develop and implement your own approaches for meeting that universal goal.

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TD AMERITRADE

it did last fall, it may be difficult to take the time to review every holding that has plummeted. A less hands-on alternative is to set exit points at the time you enter a position. Set lower limits according to how large a loss you're willing to accept from a position. Then you can establish an automatic stop-loss order that will sell your shares when the price crosses your pain threshold.

Following Through

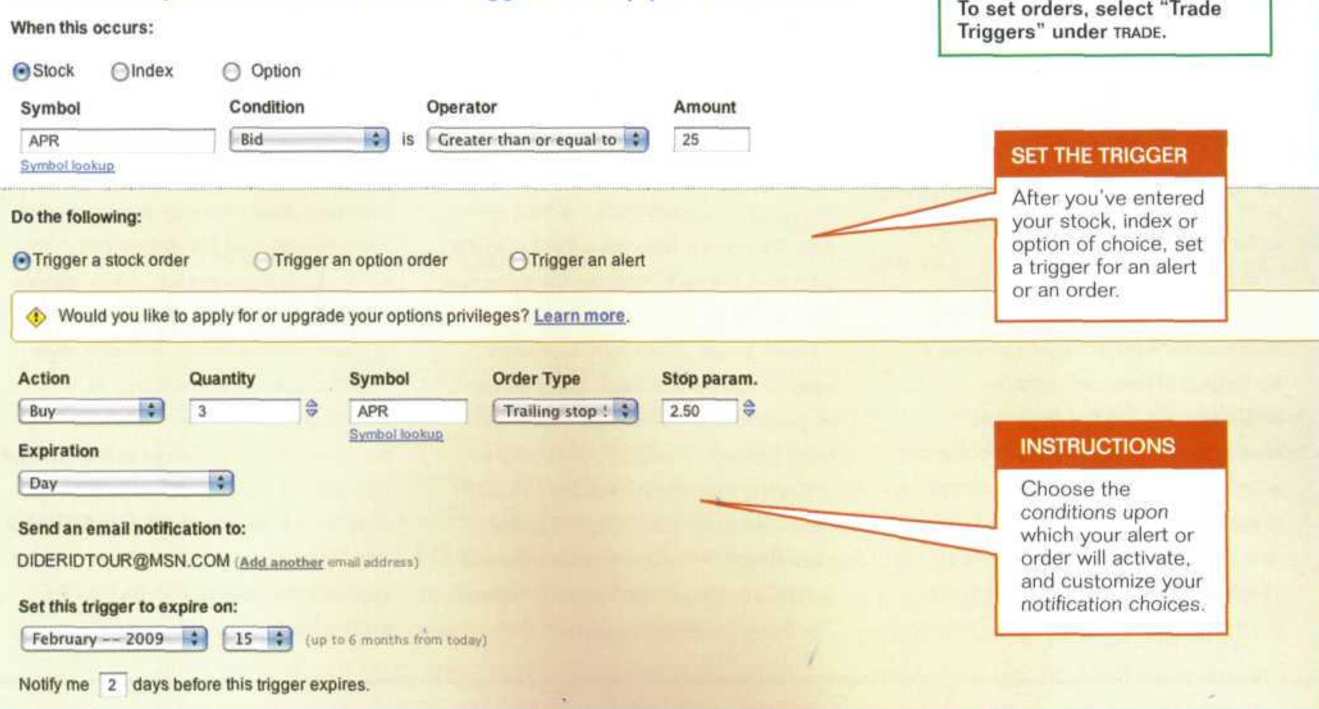
Several TD AMERITRADE tools can help you refine and execute your exit strategy. You can set Trade Triggers, for example, to send you an email alert or enter an order when a specific circumstance occurs. (To use this tool, log on to your account, select TRADE and then click "Trade Triggers.") A trigger could notify you or submit an order to sell your investment when, say, a stock reaches a particular trading volume or price, or an index cracks its next milestone. You may set as many as 80 triggers, and each will be in effect for as long as six months. You can also ask to receive notification before each trigger expires, so you can consider whether to extend it.

Execute Your Strategy

Have an exit plan in mind? Use Trade Triggers to help put it into motion

Log On

To set orders, select "Trade Triggers" under TRADE.



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"Using advanced orders is another way to stick with the discipline you established, and it's often not complicated," says Nicole Sherrod, Managing Director of Active Trading for TD AMERITRADE. For example, with a trailing stop, your exit point moves up when the stock rises. That way, you continue to have downside protection, but you'll preserve more of your gains if the price drops after a nice run-up.

Suppose an ETF you recently acquired is trading at $25 and the maximum loss per share you are willing to sustain is $2.50. On your stock order entry ticket, choose "Trailing stop $" for the order type and set the stop parameter to $2.50. That puts your original stop at $22.50. But if the stock climbs to, say, $30, your stop is moved up to $27.50 — the market price, minus the $2.50 stop parameter. Or you can set a trailing stop as a percentage of the investment price.

Changing Conditions

If you're just now establishing an exit strategy for your holdings, you may need to go through your portfolio investment by investment to add stop orders, set trade triggers or put other measures in place. But for investments you're planning to buy, another TD AMERITRADE feature, conditional orders, lets you plot out just what you want to happen based on market conditions, a holding's performance or other criteria.

Suppose a stock is nearing your buy signal and you enter a limit order, an order to buy at a particular price, say $25. If the order executes, you want immediate protection with a trailing stop, but you expect to be busy with other matters and won't be able to watch your portfolio. On the stock order entry ticket, simply check the box, "Make this a conditional order," located near the bottom of the stock and options order entry pages under TRADE. Then select "One triggers another (OTA)," which means if one order executes, the system will automatically enter a second order for you. You're able to specify not only the conditions under which you want to buy a stock but also when you want to sell. If your buy order is executed, that triggers another order, for the $2.50 trailing stop — and neither requires your immediate attention.

You could build a chain of three automated orders by choosing "one triggers OTA (OT/OTA)." The sequence might start with a limit order to sell your 200 shares of XYZ at $50. Then if that executes, the second order could buy 400 shares of ABC at $25. And if that trade goes through, the third order could call for a $2.50 trailing stop. (To help you visualize the sequence whenever you choose a conditional order, a diagram shows the order in which the trades are set to occur.)

Another conditional order, "one cancels another (OCA)," allows you to enter two orders, but if one executes, then it will cancel the other. A common application of this order type is to bracket a position with exit points both higher and lower than the current price, say, by specifying a sell order at $30 for a $25 stock as well as a $2.50 trailing stop. When one trade occurs, the other is no longer needed and therefore is canceled.

This can be linked to a prior trade as well with "one triggers OCA (OT/OCA)," which allows you to establish a bracket when you take the position, says Mike McGrath, Director of Trading Products at TD AMERITRADE. "You enter the position with the first order, and if that fills, it automatically enters the bracket using an OCA." So you could start with a limit order to buy at $25, and its execution would automatically enter both a sell at $30 and a $2.50 trailing stop, only one of which may be executed.

With a new year beginning, now may be a good time to make sure you have sensible exit plans for all your positions and review whether your current portfolio holdings still serve your financial objectives. Pay particular attention to your best and worst performers, Giroux advises. "If one of your big winners has grown to between 5% and 10% of the total portfolio, you're taking on more risk than you probably intended and should consider trimming back the position." And though you may have pruned some losing investments at year-end to gain potential tax advantages, it doesn't hurt to take another look to see whether it's time to move on from holdings that no longer serve your purposes. Often, a timely exit is better than a long good-bye. ■ *(2, 3, 4, 5)*

TAKE ACTION

Ask Questions

Call 800-669-3900, contact your investment consultant, or visit a TD AMERITRADE branch office. Consider asking

- How can I minimize investment losses without selling a promising investment too soon?
- What's a possible strategy for preserving profit in a volatile market?
- Which TD AMERITRADE tools and services can help me take the emotion out of trading decisions?

See "Important Information," page 20, to reference the numbers following this article.