The Importance of "Sell Discipline"

A whitepaper from CH Wealth Management, LLC

It seems that today, though there is no shortage of investment ideas and opinions, everyone is more or less singing the same tune. The standard advice is to buy quality and hold forever. "Don't worry, it'll come back" is the mantra heard time and again from financial advisors.

And, on the whole, that is fine advice. After all, it has worked reasonably well in past markets—there is even an entire academic school of thought dedicated to this idea: Modern Portfolio Theory.

However, for many investors, there is a deeper problem with this idea: a retiree living off of withdrawals from her portfolio does not have the same experience as a pre-retiree who is not making withdrawals. Though they may have the same long-term average return, they will not have the same realized experience. It is easy to see this concept in the chart to the right.

This law is called the "sequence of returns." And it is important.

Important because having too many excessive losses, especially at the very beginning of your withdrawals, can lead to catastrophic investment results, as our case study shows.

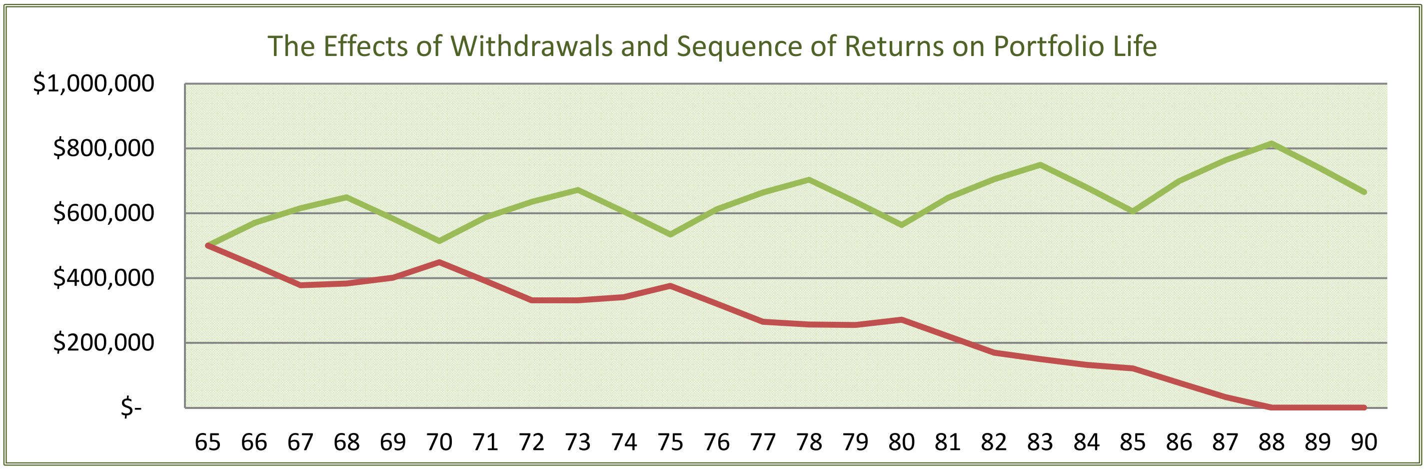
In the chart to the right, both investors begin with the same portfolio value. Both take a 6% withdrawal throughout retirement, and both achieve a long term average return of 8%. You can see, however, the drastic effect that the *order* of those returns has.

Yearly Total Returns with an ongoing $30,000 (6%) Withdrawal							
Age	**Good First Years**			**Bad First Years**			
65	-	**$**	**500,000**	-	**$**	**500,000**	
66	22%	$	570,000	-4%	$	440,000	
67	15%	$	615,500	-5%	$	378,000	
68	12%	$	649,360	12%	$	383,360	
69	-4%	$	583,386	15%	$	400,864	
70	-5%	$	514,216	22%	$	449,054	
71	22%	$	587,344	-4%	$	391,092	
72	15%	$	635,445	-5%	$	331,537	
73	12%	$	671,699	12%	$	331,322	
74	-4%	$	604,831	15%	$	341,020	
75	-5%	$	534,589	22%	$	376,044	
76	22%	$	612,199	-4%	$	321,003	
77	15%	$	664,029	-5%	$	264,953	
78	12%	$	703,712	12%	$	256,747	
79	-4%	$	635,564	15%	$	255,259	
80	-5%	$	563,786	22%	$	271,416	
81	22%	$	647,819	-4%	$	220,559	
82	15%	$	704,991	-5%	$	169,531	
83	12%	$	749,590	12%	$	149,875	
84	-4%	$	679,607	15%	$	132,356	
85	-5%	$	605,626	22%	$	121,475	
86	22%	$	698,864	-4%	$	76,616	
87	15%	$	763,694	-5%	$	32,785	
88	12%	$	815,337	12%	$	-	
89	-4%	$	742,724	15%	$	-	
90	-5%	$	665,588	22%	$	-	
	8%	**AVERAGE RETURN**		*8%*			

Even though both investors had the same *average* return of 8%, only one investor's portfolio lasted all the way to age 90. All this simply because one experienced moderate losses for the first two years, while the other experienced gains.

And this makes sense when you think it out.

By making consistent withdrawals, those losses get locked into an investment portfolio. When those investments do recover, there are fewer dollars to put to work in that recovery.



All of this to point out the importance of having sell discipline.

Now, there are two parts to that term.

Sell. Firstly, this is acknowledging that there *is* a time and a place to sell an investment. Sometimes it may not be appropriate to hold an investment, no matter its quality.

Secondly, this is planning an exit strategy from the get-go. Not simply buying and holding (or buying and forgetting), this involves constantly updating and re-evaluating an investment position.

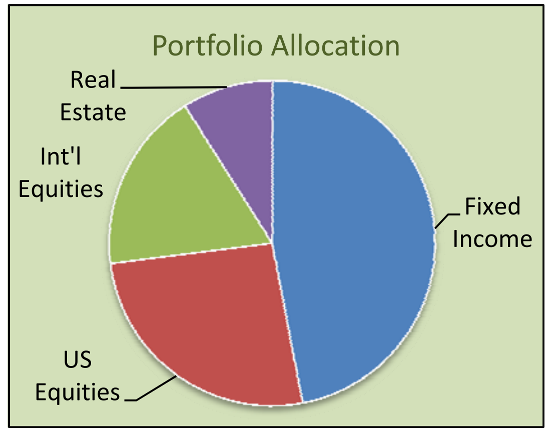
Discipline. Selling willy-nilly or for emotional reasons can be catastrophic for investors! There must be processes and procedures in place to execute this strategy. It is important to let data and rationality—not emotions—control these decisions.

Selling an investment should always be just as thoughtful as purchasing it. And there can be numerous reasons to sell beyond the change in "quality," which is so often bandied about as the only legitimate reason.

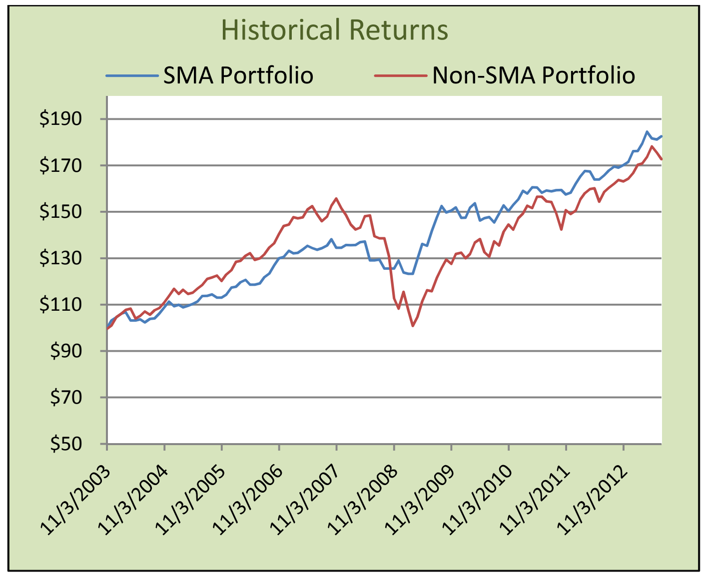
It is also very important to note that this does not advocate abandoning traditional investment practice! Diversification, while not a guarantee against loss, is critical in balancing long-term portfolio risk and reward.

What this does seem to advocate is an investment process that incorporates sell discipline.

Both our own in-house research and independent studies[1] have shown that defining even a simple sell target can increase portfolio returns while reducing risk.



This example shows two portfolios. The first is a simple buy-and-hold portfolio and the second is a systematic portfolio with instructions to sell anytime the price of a holding falls below its 90-day simple-moving-average (SMA)[2].



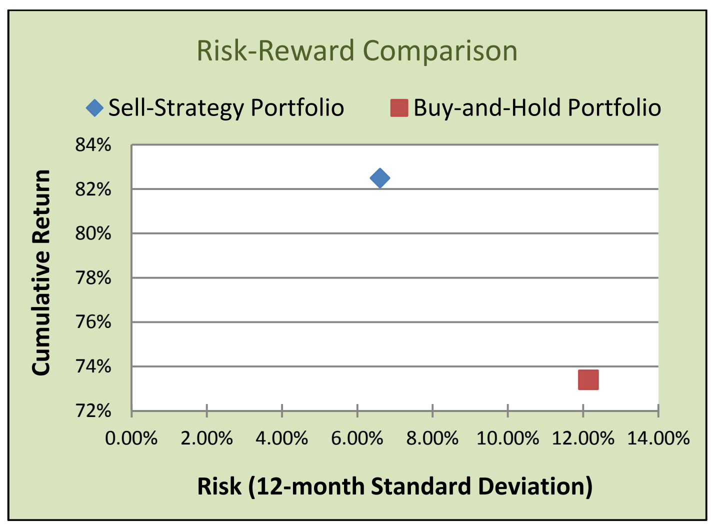
Both portfolios begin with the following allocations:

47% - Fixed Income (represented by State Street Global Advisors' ETF: AGG).

26% - US Equities (represented by iShares' ETF: IWV).

18% - International Equities (represented by iShares' ETF: EFA)

9% - Real Estate (represented by iShares' ETF: ICF).



What you can infer from the charts to the right is what the data bear out. With even this simple strategy, the risk (measured in volatility) of the sell-strategy portfolio is reduced by almost half, and the 10-year cumulative return is increased by nearly 10 percentage points.

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[1] Faber, Mebane; *The Journal of Wealth Management,* "A Quantitative Approach to Tactical Asset Allocation", May 2006 (updated February 2013).

[2] A simple moving average (SMA) is calculated by adding the closing price of a security for a number of time periods, then dividing this total by the number of time periods.

So, what is the takeaway for investors?

It seems clear that along with diversification and other traditional portfolio techniques, incorporating sell discipline into an investment portfolio can be helpful in achieving your long-term goals.

Our investment process is derived from data, informed by research, and driven by years of experience. The memories of 2008 still linger, and incorporating those lessons into a broader, holistic strategy seems entirely obvious.

There is certainly no strategy that can guarantee against losses—even excessive ones. But incorporating a researched, data-driven process aimed at mitigating the effects of excessive losses surely cannot hurt.

And an investor's "sell-strategy" is just one tool. One tool used to compliment and augment the others. Nothing stands alone.

Neither should you.

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