Investing Backwards

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What Many People Think They Know about Investing is Backwards

Some people believe that if they can just find the right stock, they'll become rich. They see investing as a 3-step process: a) find a winner, b) buy it, and c) hold onto it forever. If it is "the right stock", riches will shower down on them.

There are only two problems with this notion. First, you can go through your whole life without finding a big winner. Second, even if you find a big winner, you are going to have to sell it someday (unless you are happy basking in the glow of your monthly statements).

If you are in it to make money, here is how investing really works:

> When you are looking for an entry, you are an analyst. Once you are in a position, you have to become a risk manager. A lot of people are good at analysis, but only those who can make the transition to risk management once the position is open will make money in the markets.

The key to making money is not knowing what to buy or even when to buy it. Buying is easy. Selling requires a plan and discipline. It takes both a buy and a sell to put money in your pocket. There is potential in buying, but capturing profit (and minimizing losses) is in the selling. That is the heart of risk management.

Making and sticking to clearly defined rules on when to sell any given security are how you capture profits and avoid big losses. There are a variety of approaches to risk management.

A number of people recommend selling a stock any time it declines 20% or more from its last high. Some prefer 10% from the last high. There is at least one successful fund that uses a strict 7% stop on all their investments.

Some people sell when a security breaks down through support. Other investors use a 50-day average and a 200-day average to decide if a stock should be sold. The respected market analyst, Ned Davis, suggests using a 13-week average and a 34-week average to make both the entry and exit decisions.

I've heard some people say, "Yeah, but if I sell it and then it goes up some more then I'll miss out." They see selling as a terminal event. They think when you sell it, that's the end. It takes some people a long time to get comfortable with the idea that even good securities get beaten down sometimes, and just because you sold it last month or last quarter doesn't mean it's not a good buy now that it is going up again.

There is psychological resistance to selling. If you made money, it makes you fear missing out on making more. This is *greed*. If you lost money, selling is proof you made a mistake. This is *ego*. You must overcome these psychological weaknesses in order to make money.

Manage your risks and the profits will come.