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Sell the losers, but not just to save tax

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At times, people are faced with a situation when they suddenly need some funds quickly, either for a wedding in the family or for some business requirements, and are forced to sell some stocks. As an investor you look through your portfolio, and find some are winners worth more than their cost of acquisition but some are losers. Say you hold Stock A and Stock B. Stock A is a winner, currently in profit, and Stock B a loser, worth a lot less than your price. Prices of both have been stable in the recent weeks. Which stock are you more likely to sell?

If the same question is designed as a choice between a decision of pleasure or the one that causes pain, you will most certainly sell Stock A and enjoy your investment prowess. A rational investor, on the other hand, would have a comprehensive view of the portfolio and sell the stock that is least likely to do well in the future. In our example, it is Stock B.

Daniel Kahneman, the world's the best known psychologist alive today and a Nobel prize winner of 2002 for his pioneering work on decision making and uncertainty, in his recent book 'Thinking, fast and slow' narrates a conversation his partner had with a financial advisor. Apparently, the financial advisor asked him for a complete list of the stocks in his portfolio, including the price at which each had been purchased. When he as was asked, "Isn't it supposed not to matter", the advisor looked astonished. The investor has set up an account for each share that he bought and he wants to close every account as a gain. Psychologists call this as 'disposition effect", a bias relating to the tendency of selling winners rather than the losers. Peter Lynch, the legendary fund manager, talks about this "plucking the flowers and watering the weeds" in his book as well.

This is irrational behavior as the future performance of a stock is unrelated to your purchase price.

Even worse, is the decision to invest additional resources in a losing stock after realizing proceeds from booking profits in a winner. This is called as the 'sunk cost fallacy', a costly mistake that most investors, big or small, often make.

But what's that got to do with taxation for investors? Taxes provide a strong incentive: realizing losses reduces your taxes while selling winners exposes you to taxes. Investors sell more losers in March for year-end tax planning but for the rest of the 11 months of the year, mental accounting prevails over financial common sense. The quantum of tax benefits of selling a loser, instead of a winner, may differ from investor to investor depending on the costs.

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However, in most cases investors overdo their recent enlightening. The moment they are convinced on the merit of a sensible idea, they tend to have a relook at their portfolio in a manner Charles Munger expresses as, "To a man with only a hammer, every problem will look like a nail".

Hence, next time you are advised by your financial advisor to rejig your portfolio, don't pick the ones just because they are trading above your cost. When your tax advisor advises to sell the loser stock during March for saving tax, don't decide entirely based on tax reasons. Tax is not the only reason that you must consider to sell the losers and hold on to the winners. While picking the stock to be sold shall be based entirely on the future consequences and payoffs, tax incentives in booking a loss can itself may make to get out of what otherwise would have become great investments just because the stock had a breather after you purchased.

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