When to sell small caps

by Tom Tresnowski

There are two vastly different psychological forces at play when deciding to sell small cap stocks: One is selling for a loss and the other is selling for a profit. Fine tuning one's approach toward selling in both situations is much harder and more important in the long run than buying stocks. With small caps, one's selling strategy is extremely more important than buying because of the dramatic moves to the upside and downside that can occur with these stocks.

Selling stocks for a loss – Most people have a hard time admitting a mistake and they provide tons of excuses to hold onto a bad decision after it is made. This is part of being human. We are taught that winning is everything. Losing diminishes us as a person…we lose self-confidence, we become angry and tend to approach future endeavors with fear. It is estimated that the top traders still lose 75% of the trades they make. This means that your odds are against you when you enter into a trade. With this reality present, the right approach is to admit a mistake and get out of a losing trade before it becomes a large loss. Everyone has their own tolerance, but generally I have seen exit criteria on losses between 2% and 8%. By cutting down on your losses, you provide an insurance policy that protects your capital in the long run. Some use hard stops placed with your brokerage, however with this approach, market makers will often come down and execute your sell order for many of these small caps. A mental stop is when you see the security dropping down to a threshold you have and then you execute the sell order. In either case, you need to make the execution of your losing trade an automatic function of your trading strategy and leave that human winning tendency at the playground.

Selling stocks for a profit – When your stock is trading above your purchase price, your mind goes into a whole host of euphoric states. You start computing the monies you have made and how you can use that money to buy something. Your ego/self-confidence goes higher and bragging to others about your brilliance tends to occur. At the same time, most people will tend to sell their winners early because of that fear of a loss (winning trade moving to a loss, called loss aversion) along with other short term excuses. This is major problem with most traders. Every stock has an unlimited upside to it. My previous article regarding Intuitive Surgical (ISRG) highlights one such example. Your strategy needs to have specific selling criteria for profits. Examples include selling when it approaches a 20% gain, selling the cost portion of the trade so that any upside to the stock is pure profit and for the more advanced traders, selling profitable trades based on a combination of technicals and fundamentals of the stock along with the industry group the stock belongs to and overall health of the stock markets.

Studies have shown that the most successful traders in the past attribute their successes primarily to the aggressive containment of losses and not prematurely selling the few winners that make it big.

About the Author

Tom Tresnowski is President & Portfolio Manager of Vincose Capital Management, LLC. For more information, visit http://www.vincose.com