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August 2020 Monthly Commentary

In this month's Commentary, we discuss selling stocks in a down market. While our Group does everything in its power to prevent our clients from selling stocks when the market declines, unexpected expenses don't wait for the stock market to recover, and sometimes one simply has to sell stocks to cover an expenditure. Our Group has strategies in place for dealing with this dilemma, which we discuss below.

First, you may wonder, what's the harm in moving to a more conservative allocation of lower stock exposure and more bond exposure after stocks have fallen? Research from DALBAR has shown that for the twenty years ending 2017, investors in a blended portfolio of 60% stocks and 40% bonds earned an annual return of 2.6%, whereas the portfolio itself earned a return of 6.8% a year. This huge disparity between what the investor earned and what the portfolio earned results from investors buying and selling their investments at the wrong times, including selling stocks after the market fell[1].

Our Group's first line of defense in preventing clients from selling stocks in a down market is maintaining a balanced allocation between stocks and bonds for clients living off their assets. When the market declines, clients then have a stable source of funds to draw down from bonds and cash until stocks recover. Our second line of defense in preventing clients from selling stocks in a down market is to coach them through the difficult period and help them realize that all corrections are temporary, including the worst one of our lifetime, which occurred in 2008.

But sometimes you have to sell stock in a down market to cover an expenditure that comes up. Everyone has heard the investment wisdom "buy low, sell high." The good news is that with our Group's investment strategy, it's still possible to sell high during a market decline. Our Group's investment strategy of maintaining diversified client portfolios of individual securities means that even in the event of a large market decline, we will likely be able to sell some selected investments that we bought at significantly lower prices, allowing us to still buy low and sell high for clients. For example, during the pandemic market decline this past March, some of our portfolio holdings were viewed as beneficiaries of the pandemic lockdowns, and their stocks did very well. These mostly included companies producing toilet paper, personal care products, cleaning products, packaged food for home consumption, and food for delivery.

We would also likely have the opportunity to employ tax efficiencies when selling stock in a down market. First, we would look to incur gains on stocks that you've owned for more than a year, as these realized gains would incur the favorable long-term-gain tax rate of 15% or 20% depending on your tax bracket, as opposed to short term gains of less than a year which get taxed at your ordinary income tax rate. A second technique we could use would be to offset your taxable gains with losses to essentially eliminate or significantly reduce the tax liability from your gains.

One important point to mention is that although we will always look for tax efficiencies when selling positions, investment decisions trump tax decisions. In the words of billionaire investor Warren Buffett, "more investment sins are probably committed by otherwise quite intelligent people because of tax considerations than from any other cause." Our Group agrees with Buffett, and when deciding between tax considerations versus investment potential when selling a position, we will give priority to investment potential.

A final point to mention in selling stock in a down market is that it can provide an investor with an opportunity to alter their asset allocation to a proportion that better matches their risk tolerance. Many investors don't realize the true extent of their risk aversion until a large stock market correction occurs. While our Group advises these clients to wait for the market to recover before reducing their stock exposure, if the client must sell investments to cover an expense, it provides a natural opportunity to reduce their stock exposure.

Best Regards,

The Crescent Group
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Sources:

(1) RBC Wealth Management