When the market is falling, as in a raging bear market, is it best to hold falling stocks for the dividends, or sell to protect profits and capital?

The answer might surprise you!

Many investors keep telling themselves: *"When the market falls, I hold onto my stocks for the dividend income."*

Many investors don't realise that the frequent bear markets and market corrections can do significant damage to the capital value of a portfolio — but we can minimise the damage. Details about how to do this are discussed in the following pages.

If we consider a definitive study of the following two options, what do you think the outcome would be? Is one option better than the other?

- Option 1 — Follow the **buy-and-hold approach**, even during market corrections and bear markets, and continue to take the dividends for income.
- Option 2 — **Strategically liquidate** stock positions, and look at reinvesting the cash elsewhere.

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A study of these two options is documented in this paper utilising a hypothetical portfolio of ten stocks with a total initial value of $100,000. This Article in Brainy's series on Share Trading and Investing (number ST-6050) provides all the details of the two approaches, and records the results. Which stocks were included in this study and exactly how did they perform? What about the details of the strategic selling approach of Option 2? How does it work? All the answers are included in the following pages.

You might wonder why many investors continue to not believe, or disregard, studies like this one. One possible reason is to do with ***cognitive biases.*** Some investors relish the chance to improve their portfolio performance, while others seem to keep the blinkers on, and ignore what might seem to be a very sensible and logical alternative (especially when they might not be happy with their current approach). See the discussion about ***cognitive biases*** on page 8 for details.

Executive summary

The findings from this study are summarised in the following table.

Returns over 6 years July 2007 to June 2013	Option 1 – Hold on		Option 2 – Liquidate	
	Capital	Dividend	Capital	Dividend
Capital invested @ 30/6/2007	**$99,981**		**$99,981**	
TOTAL dividend income over 6 years		$21,535		$1,805
Reinvestment proceeds (iv)			$9,744	
Capital Value(iii) @ 30/6/2013	$79,690		$118,201	
Change in capital value (%) over 6 years:	**-20.3%**		**18.2%**	
Total capital + dividend	$101,225		$120,006	
Total return	**1.2%**		**20.0%**	

Table 1: Overall results - the returns after 6 years for the two options

Note that after a 6 year period, the buy-and-hold investor realised a total return on their investment (capital plus dividend) of a measly 1.2 percent, including more than $21,000 in dividend income. On the other hand, the strategic seller realised a total return of 20 percent.

** - The two words *trading* and *investing* are often used somewhat interchangeably.

Introduction

Many investors simply buy some shares, and hold for the long term (hence the title "buy-and-hold"). They do this for any of a number of reasons, including based on the advice of respected industry professionals who ought to be honouring investors' best interests.

However, many investors don't do the sums to see whether this approach really is sound and in their own best interests. They like the idea of holding onto the shares. After all, many of the industry professionals keep confirming that it's the right thing to do. And many investors don't realise that we can tell when a bear market is close, and they also don't realise that the damage can be significant and long lasting and that we can minimise the damage.

On the other hand, many of the more switched-on investors, as well as many shorter term investors and traders, know better. This study helps us understand the detail.

How to justify the selling?

Why should we really bother with trying to liquidate stocks, instead of riding out a market correction or bear market? Well, on the Australian share market between 1986 and 2013 there were a number of bear markets (a fall of at least 20 percent), but there were two in particular that were very severe, where the market index did not make new and sustained highs for a number of years. In the case of the 1987 crash it was more than 9 years — see the chart in Figure 1 below.

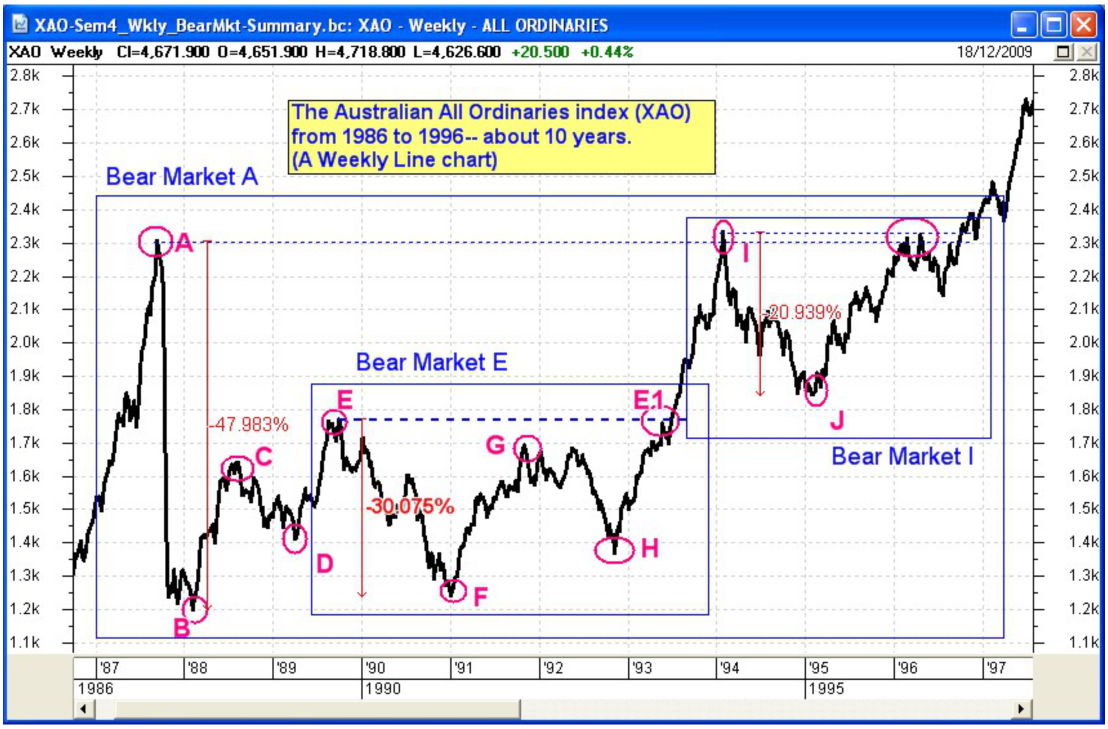

Figure 1: The bear market that followed the 1987 market crash.
The index did not reach new and sustained highs for nearly 10 years,
and suffered two more bear markets along the way.

Not only that, the statistics show that a bear market or a correction (a fall of more than 20%, or 10%, respectively) comes around at least every three years and it can take a long time to make new and sustained highs. If only we can spot these early and avoid them — and we can! Despite what the industry experts tell us, we can "time the market".

So if we can sense that a bear might be around the corner, how do we make the decision to sell stocks? On what basis? Well, one simple example is included amongst the details below.

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