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Special Report

Investing Essentials Series

Part 3
Stop Losses

Investing Essentials

Part 3: Stop Losses

If there's one essential to investing that requires the mentality of a champion to conquer, it is this one. Investing as a whole forces you to act in spite of your emotions constantly. It almost becomes fun to know that the way to make a fortune is by acting the exact opposite of what the rest are doing. This reminds me of "Black Monday," when Warren Buffett was probably celebrating the fact that so many terrified so-called "investors" sold their Coke shares for much less than their true value, allowing Buffett to accumulate Coke shares at a cheap price. Almost 30 years later, this position in KO returns nearly 50% per annum (not a typo) to BRK shareholders via dividends on the original investment. This was absolutely the right decision to make that fatal day, yet most did the exact opposite.

Another decision that all investors are horrible at is knowing when to sell a stock.

Read this report carefully, as what I am about to share will absolutely revolutionize how you invest starting now. When you buy a stock, you are now part of the owners of the company. Your investment will succeed if the company can increase its profits over the long-term. In order to do that, it must have a competitive advantage that allows it to crush other companies. That advantage is "the story" of the company. To illustrate a "story," imagine you are in an elevator with a friend and he asks you why you invested in a given stock. Well, you have about 60-90 seconds to explain why you bought shares. Here's an example: "I bought XYZ shares because they are now expanding into emerging markets, where they will be the first to market. I also love the fact that the CEO has a compensation that derives mostly from profits and not a salary, the low debt levels, plenty of cash on hand, and a fat dividend." There you have it. This was the "story." As long as the company sticks to it or improves upon it and has historically outperformed the S&P 500, you have every reason to own the stock, no matter what the price is doing. That's because the company is becoming better every day, and the market will price it accordingly as time goes by. If "the story" changes, you need to start thinking about selling. The best reason to sell, according to the legendary Peter Lynch, the most successful fund manager in history, is BECAUSE THERE IS A BETTER INVESTMENT. Sometimes cash is an even better investment than a stock. Cash is a powerful position. Read our Classic Issue "ACTIVITY DISEASE" to understand how important it is to your success.

Since emotions play a major role in investing, fear is the most dominant state of mind. When the market corrects or crashes, many phenomenal businesses lose 20%-25% in price, all the while the business fundamentals remain strong and keep improving. In other words, the business gets better, while the price is cheaper. It sounds fantastic, but many investors can't handle this kind of pressure. The best thing to do in this case is obviously to buy more shares. The second best thing is simply to hold. The worst thing to do is sell.

Part 3: Stop Losses

Sometimes a company will have a bad quarter or a bad year. If you feel unsure about the company's future prospect, here is when you should apply a trailing stop loss.

Cutting a loss is a tough decision – it's that moment when you admit to being wrong and failing at analyzing the business. It's a mentally brutal task, but it is a must.

From my perspective, a trailing stop loss is an easy and efficient strategy of preventing you from making wrong decisions when emotions overwhelm you. Instead of making a bad situation worse, you simply SELL when things get complicated and you lost your edge.

How do you apply a trailing stop loss?

You set a given percentage below the highest price this stock reached when you sell. Here's an example: if you bought XYZ at $23 per share and it rose to $35 and you are using a 20% trailing stop loss, you will sell the day after it hits $28, thus locking in profits and avoiding farther price declines, since the company is clearly not performing well.

If you bought at $23 and it goes down 20% to $18.40, you do the same thing.

If you follow essential #2 and kept the entire position to under 10%, then you lost 2% of your overall portfolio, and that is a miniscule loss that won't shake your confidence, and will provide cash to invest more wisely.

My hope for you is that you learn to accept and embrace that no one is right 100% of the time, and that means that you must protect yourself from yourself.

In our view, the most important reason to use trailing stop losses is for times of uncertainty. If you are convinced and sure about the company while the business is losing share price but the fundamentals are solid, then don't sell.

If your conviction is low, use a trailing stop loss. It will save you from yourself.

Warren Buffett has earned the lion's share of his fortune in 15 companies!

The lesson here is simple: your portfolio will have a few losers, so you need to cut losses early. It will have a number of mediocre performers, a couple of performers that will yield as much as the major indices, and a few winners that will make you richer than you can now believe. So what if you lose money here and there?

I have founded and managed more than 5 businesses in the past decade. 1 was a complete time waster. 3 of them were mediocre businesses, and 1 flourishes and earns 5 times the average national salary alone. My investing experience has produced better than average returns, putting me in the 4% of the people who eat 64% of the stock market wealth. Never allow a loser to hold you back – take a small hit to clear way for big winners. It's tough to do, but is absolutely the right move.

I highly recommend immediately reading Investing Essential P. 2 (Position Sizing), as combining both of these is what separates professionals who earn money from the 96% who can't make this work for them.

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