



Head for the exit

Knowing when to get out of an investment is just as important as finding the right place to get in, as trader and author Tony Loton explains

As viewers of the popular TV show *Dragons' Den* will know, experienced investors do not part with their money unless they have a clear idea of when and how they will get it back. This goes for private equity, venture capitalists and other professional investors. They only go in if they have a well-defined exit strategy.

Many retail investors don't think about exit strategies at all. They define their entry conditions by screening stocks, examining charts and following the news, but they barely give a second thought to their exit conditions.

KNOW THE WAY OUT

Defining an exit strategy allows you to close a position when you want to: when you reach a profit target, when the tide turns against you, or when the fundamentals no longer

hold. If you don't have an exit strategy that allows you to sell out when you want to, then the only time you will sell out is when you have to.

'When you have to' is usually the worst time to sell anything. That's why some property speculators look for sellers who are dealing with debt, divorce or death. They're looking for people who have to sell. Similarly, when a recession bites and times are tough, you might find yourself having to sell some of your investments to realise some cash. And you can guess where the stock prices will be sitting when that happens.

Why not take more control by managing the whole lifecycle of your positions, from entry to exit? Here are some of the more common exit strategies. They do vary in complexity, and you need to find one that fits

with your investment strategy. In each case, however, the point is to define what your exit strategy is in advance, at the time you enter a position, and to stick to your guns.

EXIT WHEN YOU REACH YOUR PROFIT TARGET

Some traders and investors set a profit target for their positions. If you think that a stock will rise by 30%, you might decide to exit when the price had risen by 25%, to allow for some leeway in your estimate.

You can define this exit strategy in advance by placing a limit order to sell at a specified level (say 25%) above your purchase price.

EXIT WHEN THE TREND CHANGES

Some traders and investors don't like profit targets because they want to 'let their profits run'. By selling out at 25%, they might miss out on the 100% rise!

These traders will sell out when the price falls rather than rises. It sounds counter-intuitive, but it can work if you place a trailing stop order to track the rising price upwards and to (automatically) sell out if the price falls back by a specified amount.

Suppose you set a trailing stop order to trail 5% below the current market price. If the price rises by 30%, and then falls back to the stop level, you would have achieved the same end result as in the profit target example. If the price rises by more than 30% before falling back, you will have done even better.

I've kept the maths simple by ignoring the bid-ask spread and the fact that a trailing stop set initially at minus 5% will not stay at minus 5%. If the price doubles (lucky you!) then the same trailing stop level would now be at the equivalent of minus 2.5% – unless you adjusted it.

This exit strategy also has the welcome side effect of 'cutting your losses' as well as 'letting your profits run'. If your chosen stock doesn't rise at all, and in fact falls back soon after purchase, it should fall only as far as the 5% before triggering your stop order.

EXIT WHEN THE FUNDAMENTALS CHANGE

'Fundamentalist' investors buy stocks that have high dividend yields, low price/earnings (P/E) ratios, or low price/earnings to growth (PEG) ratios. But how many of these investors decide at the outset that they will sell the stocks once the attractive fundamentals no longer hold true? A high growth (low PEG)

stock can't grow forever, and there may come a time when the initial entry conditions no longer justify holding on to the stock.

The key here is to review your portfolio at regular intervals and ask yourself one simple question: "Would I buy this stock now?" If the answer is "no", then maybe you should consider banking your profit or cutting your loss.

PARTIAL EXITS

Whichever exit strategy you choose, you might be reluctant to sell out your previously favoured stock completely. So why not exit gradually, for example by selling a proportion of your holding each time the stock price reaches an intermediate profit target? You'll be assured some profit while still being well positioned for any revival of fortune.

MULTIPLE EXIT STRATEGIES

You might think of the three exit strategies as discrete choices, and that you must choose one when you enter a position. When you buy a stock, you might choose from the following strategies:

- I will exit this position when I reach my 25% profit objective
- I will exit this position if the price falls by 5% from any peak
- I will exit this position when the PEG ratio rises above 1.5

The whole point is to define what your exit strategy is in advance, and to stick to your guns

The values 25%, 5%, and 1.5 are not magic numbers that will guarantee your wealth, health and happiness. I have chosen those values simply to make the example easy to follow.

But who says you have to choose just one exit condition? Why not simply combine all three? I will exit this position when I reach my 25% profit objective or if the price falls by 5% from any peak or when the PEG ratio rises above 1.5.

You would implement the combined exit strategy by placing a limit sell order at 25% above your purchase price, by placing a

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trailing stop order at 5% below your purchase price, and by regularly monitoring the PEG ratio to ensure it does not go too far beyond its notional 'fair value' figure (which, by convention, is deemed to be '1').

Theoretically, at least, you would never lose more than 5%, you could secure a profit of up to 25%, and you would never be caught on the wrong side of the fundamentals.

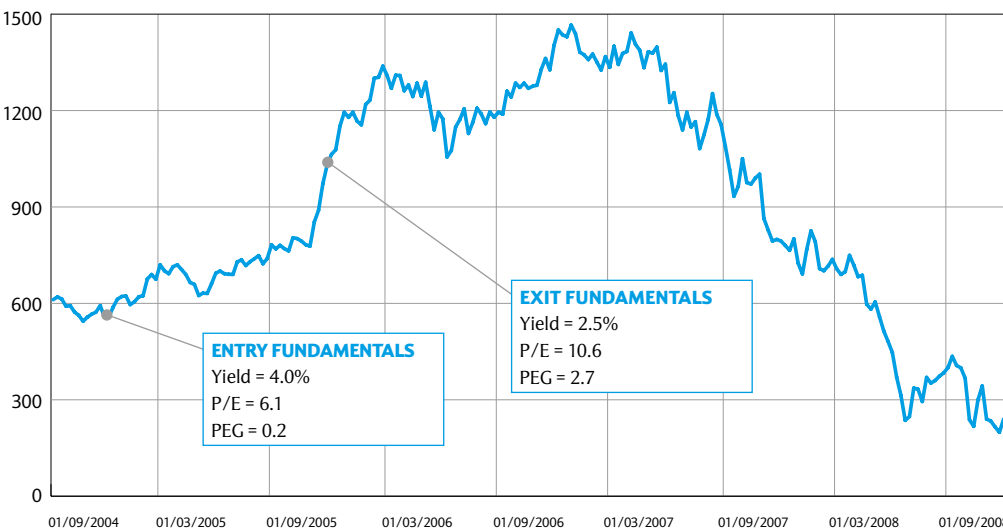
Most importantly, by defining your exit strategies at the outset, you would be selling out when you want to rather than when you have to. ☒

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Order types

To learn more about trailing stop orders, limits and other order types, visit the Barclays Stockbrokers website, click on Education and select 'Introduction to Order Types'. You can find fundamentals, such as PEG, on the Company Info page when you view a company in the Research Centre.

EXITS IN ACTION



At the start of 2005, Persimmon (PSN) had a reported Dividend Yield of 4%, a reported P/E of 6.1, and a reported PEG of 0.2. For many investors, that's three good reasons to invest in the stock.

The investor with a particular exit strategy decided to close his position when the PEG shot up and the fundamentals changed. As a result, he realised a reasonable profit. The investor without an exit strategy was left holding the stock as it fell during 2007. As of December 2008 (shown left), Persimmon's share price is less than his entry price.

The past performance of Persimmon is not an indicator of future returns.