When You Are Wrong

By Sunny J. Harris

No one invests correctly all the time. But what do you do when you are wrong? Here are some thoughts about what to do when you have a position and, for whatever reason, you start wishing you didn't.

Test the Original Thesis

When things haven't worked out like you originally planned, the first thing to do is check your thesis, the reason why you bought this stock in the first place.

A thesis should be an argument behind why the stock was going to go up. It may be simple, such as "demand for semiconductors will be rising and volume increases will not depress the price." This could justify a purchase of semiconductor stocks.

But six months later, if the price of your stock never starts rising, you should go back and check whether your thesis came true. If chip prices did rise, but your stock didn't, the reasoning just didn't work. It happens. But if chip prices never did rise, and you now think they won't, then selling the stock is the only logical conclusion, even if it means a loss.

"Because it is going to go up in price" is the worst possible thesis. In fact, it isn't a thesis at all. If this is the only reason you have for buying a stock, you are taking huge risks. Even momentum players have some kind of technical analysis or other identifiable reason for taking a short-term position.

If your original thesis now appears to have been wrong, sell the stock. For example, many people purchased Y2K software stocks in 1996 on the thesis that the Y2K problem would mean millions, even billions, in revenue for Y2K companies. After peaking in 1997, Y2K stocks went into a general decline. The thesis of big spending was never justified as quarter after quarter showed. Investors who deduced early that the thesis was wrong, and sold at a loss, saved themselves an even bigger loss later.

If your original thesis is still believable and you think it's true, then you should hold onto the stock. In fact, the lower prices may simply mean the stock is an even better opportunity than it once was.

Take the Loss

Holding onto a stock because you just don't want to take a loss is one of the most common ways to lose even more.

We all hate to lose money. But the "I'm getting out of this dog just as soon as I hit break-even" attitude has neither a thesis, nor a timeframe. It is just wishful thinking.

The problem with this attitude is that you miss other opportunities for the money tied up in the losing position. Often, dumping the loser and finding a better investment is a faster way to get back to "break-even."

A Hold is a Buy

Forget about how Wall Street firms grade stocks.

When Wall Street says Hold, they often really mean Sell. And when a money manager says he/she is holding, not buying, it takes into consideration the rest of his/her portfolio.

But for a single position, holding a stock is the same as buying the stock, as far as the money in that stock is concerned. If you didn't hold the stock today, would you put the same amount of money as you have in your losing position, into the stock? If the answer is no, why are you holding now?

The Inadvertent Long-Term Holder

All too often the following occurs: a trading position turns into a long-term investment because the investor refused to take the loss.

For example, you buy a stock on takeover rumors, or as part of a momentum play, but you were wrong. The takeover rumor turned out to be just a rumor, or you were the last guy in line at the momentum game. In either case, you bought at the top, and the stock has been going down ever since.

So you hold, thinking it will turn around soon. But it doesn't.

Now what?

This is the worst way to take a long-term investment in a stock. If the long- term story doesn't really grab you, what are you holding this stock for anyway? Even worse, if you find yourself researching the stock *after* you've bought it, it is harder to be critical about what you learn. You naturally want to hear good news, and only good news.

Learn From It

Things don't always work out. Even the best investors lose at times. But the best investors know that and move on.

We all like to think that making money means we were smart. Maybe even smarter than everyone else. But the truth is that sometimes dumb investments make money, and smart investments lose money.

Just because a stock goes down doesn't mean it was a dumb investment. All investments are risk/reward decisions, and sometimes the risk side is what wins out. But it doesn't mean it was the wrong bet. When that happens, selling at a loss is the smart move.

But when you do make a dumb investment, and we all usually know it when it happens, it's usually better to undo it, even if it means taking a loss.

We're all wrong sometimes.