

## Why **TAKING** a Paper Loss Can Be Beneficial

Many people say that they don't have a loss until they actually sell the stock or fund and make the loss official for tax purposes. We disagree. Read the valuation on your account statement and the value is down. If you cannot sell it for what you paid, you do not have as much wealth as when you started. If you passed away and left it to heirs, they would notice that you lost money. Having dealt with this sometimes-debated issue, let us move on to the topic at hand.

Actually realizing (closing out) a loss can provide an investor with both financial and psychological benefits. In today's bad economy and depressing market climate, these can have welcome value! So, what ARE such benefits?

To be clear: we are not saying losses are wonderful things, but when one has them it can be an opportunity to proverbially 'turn lemons into lemonade.'

#1. Removing the loss from your daily, weekly, or monthly view provides a relief from nagging pain. Pain is real for investors and traders; it colors their thinking and thereby hampers future effectiveness and financial success. The paper loss is real, but we need not continue being frequently reminded of it once it is closed out.

#2. Removing the losing stock or fund from your portfolio may improve overall future performance. In the present depressed market condition, most stocks are down regardless of corporate outlook. But in more normal markets stocks that are down probably have poorer prospects than others that are trending higher. Thus by selling out a losing position one may well be shedding a future laggard or even a company in serious trouble. Letting the dogs out is good.

#3. Selling out an arguably sub-par performer releases investable capital for possibly more productive use. The cash generated from the sale allows an investor to consider new purchases.

#4. The availability of cash should drive sharpened and fresh thinking. What is the best strategy currently? Perhaps holding cash to see if greater bargains develop. But equally, perhaps buying a stock one had previously admired

but was unwilling to pay margin interest to acquire. A fresh look at the economy, the market, and individual industries and stocks is always a healthy exercise.

#5. Actually taking a loss (moving it from the paper to the realized category) creates a tax-loss asset for the investor. The annual limit is \$3,000 for singles and marrieds filing jointly, and half that amount each for married individuals filing separately. If the loss was long-term in nature, the present 15% tax rate means that a \$3,000 loss produces a tax savings of \$450. On short-term losses, at a 25% rate, the tax asset is \$750. (For many states, an average tax rate of about 5% will produce a small added tax savings.) While many see this tax-reduction asset as only a distantly received amount (when next spring's taxes are computed and filed), some may have the option to reduce interim estimated tax payments and thus to recoup the cash sooner.

#6. Few investors may have looked at the situation this way, but in the case of a large loss the tax asset can actually exceed or substantially add onto the sale proceeds. The present extreme distress in financial stocks provides many a ready example. Little more than a year ago, Citigroup was traded at \$31.50; it changes hands when this was written at \$1.50 per share. An investor with a tax loss of \$30 on paper can acquire a tax benefit worth \$4.50 per share (assuming a long-term loss negatively taxed at 15%) when selling the stock for only \$1.50, for a total value of \$6 in hand. One might say it is clearly better to put the stock and its holder out of their misery than to keep it as a live position at \$1.50 !

#7. People have a difficult time mentally with losses (they do bruise the ego!). And part of that problem often includes contradictory impulses. One resists taking a loss (might it rally back?), but at the same time many resist taking gains so they do not have to pay the taxman. Well, taking a loss by sloughing off a loser can allow nailing down a profit elsewhere that one might otherwise leave on the table at risk. This is an especially valuable factor in cases where a large loss (exceeding \$3,000) is taken. One can rebalance the portfolio by slicing off some of a major long-term winner, thus offsetting dollar gain against loss with perhaps no net tax effect.

#8. One objection some investors raise regarding taking a loss exceeding the annual \$3,000 tax-loss limit is that they cannot use the entire tax benefit right away. (This probably is just another rationalization for not facing painful reality, but that is left to the psychologists to examine.) The flip side

of that concern is that having “banked” a carry-forward loss for future years, the investor is now mentally freed from the burden of hoping to hold winners for long-term status. Taking short-term gains (including those from writing out-of-the-money options that expire) thus becomes more acceptable. And the exercise of deliberately becoming a trader to capture such tax-free gains may help the investor to develop improved buying and selling execution skills.

#9. Another objection some have to realizing an actual loss is that the stock or fund might turn around and go up; the 31-day wash-sale rule inhibits prompt loss taking. There are easy solutions to this perceived problem. First, one can buy stock in a similar company in the same industry. One grocery stock or utility replaces another, keeping the investor represented in that area. Second, one can buy an ETF covering the industry or sector and thus still be in the market. Many mutual funds of any given type are usually available, allowing a switch without delay if desired. Finally, 31 days is not an eternity. If an investor feels they must be back in the same stock, patience and later a limit order can be used.

Failing to take losses can be costly, as described above, both financially and emotionally. Traders are fond of saying that the first loss is the best loss. Hanging on often represents implementing a buy-and-HOPE philosophy. Hope is not a valid investment strategy in any market, and especially so a severe recession and bear market.