CLUB

Worried about being greedy? Here are 3 questions to ask before trimming a winner

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In this article

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Jim Cramer on Mad Money, June 14, 2022.
Scott Mlyn | CNBC

After slumping into bear market territory during the first six month of this year, stocks rallied in July and have extended their gains so far into August. This leaves many investors with a dilemma — albeit a good problem: When is it time to pare back winning positions and take some profits?

more art than science.

That said, we do have some basic questions we ask ourselves when considering a trade. These are by no means exhaustive, but are a good starting point to keep us disciplined and check our emotions — which should play no role in selling (or buying) decisions.

1. Has the risk-reward profile become less attractive?

Traders work on the floor of the New York Stock Exchange (NYSE) on May 12, 2022 in New York City. The Dow Jones Industrial Average fell in morning trading as investors continue to worry about inflation and other global issues.

Spencer Platt | Getty Images

If a stock keeps moving to the upside without anything supporting the change, its valuation can start to look pricey. This is where understanding a stock's valuation is helpful. To gauge whether a stock is appropriately priced, you can use the price-tohelp you determine whether you are overpaying or underpaying for a stock at its current price.

- A high P/E ratio means investors are paying more for each dollar of company earnings. It also suggests that investors are willing to pay up for what they expect will be higher future earnings.

Stocks become overvalued when their prices rise faster their than their earnings estimates. A very high P/E compared to a stock's peers could mean that its price may not fully justify its earnings potential. In this scenario, you are taking on more risk with the stock. The stock may be trading at a premium, reducing your risk-reward potential. This could be a chance to lock in some gains and rebuild your cash position.

Consider: stock XYZ has a $1 per share earnings estimate and is trading at $10 per share. This implies a 10 times price to earnings multiple ($10 share price divided by $1 earnings-per-share). If the stock jumps to $15 but there is no material news and earnings estimates remain at $1, the stock is now trading at 15 times earnings. In other words, the stock is now 50% more expensive and it could be time to sell for some profit.

On the other hand, if Wall Street analysts estimate XYZ company could generate $1.50 in earnings and the stock rises to $15, it is still valued at 10x earnings ($15

Jim Cramer on Squawk on the Street, June 30, 2022.

Virginia Sherwood | CNBC

- The oscillator, which is updated every day after market close, is a market indicator that shows whether the market is overbought or oversold.
- A market that is overbought can refer to a market that has had a big move up in a short period of time. The higher the oscillator gets the more overbought it is. On the flip side, an oversold market occurs when the market takes a big move lower in a short amount of time and may indicate that we have overshot to the downside. In other words, investors may have gotten too negative and the market could be due for a bounce back.

The oscillator can show whether market levels have strong, weak or neutral averages. If the oscillator goes up, we tend to get short-term cautious. Typically, a value of 5% or more may not be the ideal buying opportunity because there could be a chance to buy at lower level, unless the stock is down for some unjustifiable reason.

For example, if there is a huge market run in a short amount of time and the oscillator goes to a 7% or 8% reading, we are monitoring the overall market and looking at which of our stocks are up as potential trimming targets.

- If a stock has rallied 20% in a week, that may be a good candidate to trim off and take some profit. This decision doesn't necessarily relate to the quality of the company, rather it could be an ideal time for us to sell and raise cash, so we are ready to buy into another high-quality company that looks cheaper.

profit after the stock and its multiple increased significantly over a short period of time.

3. Should we right-size a position?

The crypto market can be volatile, but it's still attractive to young people who have "higher risk appetites," said Chris Adam of SharpRank.

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This is the most straightforward consideration: We typically don't like to let any particular stock position grow beyond 5 to 6% of our portfolio. When we start to approach that threshold, we start to sell and take profits because we want to keep the portfolio diversified. And usually, the reason why that position got this large in the first place is due to a recent stretch of outperformance. This sell decision is not a your position without a limit, you are putting yourself at risk because the reality is, there is always some risk present even in the highest-quality company, and this is out of your control as an investor.

- For example, input costs for a company could get too expensive, consumer demand may weaken, or a company may no longer have access to a certain market. No company can control 100% of the things that impact its business, so a 5% cap is a way to manage our risk associated with a single company or a select few of companies.

We decided to trim our position in Danaher (DHR) in late July after the stock rose almost 14% following its strong second-quarter earnings release. This was a discipline over conviction scenario where we needed to take off some of our Danaher position because we had built it up to the largest position in our portfolio. We still think Danaher is one of the best run companies but to keep consistent with our mantra, it was necessary to scale back on the holding. In April, we similarly sold some shares of Apple (APPL) as its weighting in the portfolio was becoming too big.

(Jim Cramer's Charitable Trust is long AAPL, CRM, DHR. See here for a full list of the stocks.)

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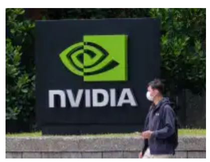

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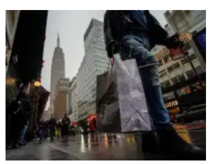

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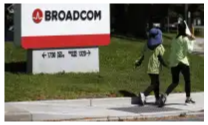

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