PRUNING a portfolio: The down market makes autumn a good time to clip losers and rebalance holdings, experts day

BY KATHY KRISTOF | Tribune Media Services
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Fall is always a good time to prune your investment portfolio, but this year it may be wise to prune early and deep.

That's because stock prices have dropped dramatically from the beginning of the year, and stocks in certain industries, such as financial services, look like they may languish for some time. That provides an opportunity for investors to harvest tax losses.

Meanwhile, market segments such as energy and gold have soared - possibly past the point where their underlying value says they should, said David Brady, president of Brady Investment Counsel in Geneva, Ill., near Chicago. That could make it a good time to take profits, too.

"This is absolutely the right time to prune your portfolio," Brady said.

How do you do it? The first thing investors need to do is look at each of the stocks they own and ask themselves whether they would buy those shares today, said Michael Kresh, president of M.D. Kresh Financial Services Inc. in Islandia.

"I ask people, 'Why do you own this company?'" he said. "'Because it has gone up' is not a good answer. 'Because my friend recommended it' is not good enough. You ought to own a company because you understand what it does and you like its prospects."

Get financially acquainted

If you haven't done so before, read a copy of the company's financial statements and quarterly reports. Familiarize yourself with what the company does and where it is going, Kresh said. Now evaluate whether today's stock price is fair, cheap or overvalued.

If you like the company's strategies and prospects and believe its stock price is fair, then leave it alone.

But if it is cheap or overvalued, you should make a second determination about whether to buy more or sell. If it's undervalued, you might want to buy more. If it's overvalued, you might want to sell so you can take a profit.

But if it started high and is now tanking, your decision is more complex: Should you hold on in the hopes the stock will bounce back? Or should you sell, using the loss to help offset capital gains when you file your annual tax return?

You will have to analyze the companies carefully to decide whether it's worth holding on to the stock.

Compare and contrast

Those who have many individual stocks might want to pull out a notebook and make a grid - one side for stocks you'd like to sell, one side for those you'd like to buy. Once you've analyzed all your holdings, focus on the sell list first. Take a look at each stock and determine whether you have a profit or loss in the holding. If there's a loss, sell and keep a good tally for your tax records.

You'll get to use those losses to offset capital gains when you file your annual tax return. If you have more losses than gains, up to $3,000 per year can be used to offset ordinary income, said Philip J. Holthouse, partner at the Santa Monica, Calif., tax law and accounting firm of Holthouse, Carlin & Van Trigt. For people in the highest brackets, doing so could shave off roughly $1,000 in federal and state income taxes.

If there's a profit, determine whether you have held the stock for at least a year. The tax cost of selling a stock you've owned for less time is far higher than selling after a year. That's because long-term capital gains rates top out at 15 percent, while shorter-term gains are taxed at ordinary income tax rates that can be 20 percentage points higher.

If the timing is close, and the potential is substantial, it may make sense to hang on to securities that have short-term gains for a few extra weeks or months to save on taxes, Holthouse said.

Now, with the proceeds from the stocks you've decided to sell, determine which shares on your buy list you can afford. Buy first the ones you think are best, putting the rest on your future hit list for when cash becomes available.

Of course, diversify

The main caveat: Be careful to keep your overall portfolio diversified. That means you should have stocks, bonds, cash, international securities and, probably, some shares in real estate investment trusts in your portfolio. The stock portion also should be divvied up among companies in various sectors.

Even if you think the best prospects are in certain industries, if you dedicate too much of your portfolio to just a few segments, your portfolio could suffer disastrous swings in value.

"It's important to look at where each stock fits in your total portfolio," Kresh said. "You want to consider whether there's a better place to invest your money."

Top and bottom

2008's best performers in the Dow Jones Industrials....

Symbol Company name Friday %change, 2008

close

WMT Wal-Mart Stores $59.70 27.2%

DD DuPont 48.04 11.8

IBM International Business Machines 118.85 11.3

JPM JPMorgan Chase 47.50 10.9

MCD McDonald's 63.98 10.7

JNJ Johnson & Johnson 69.99 7.1

DIS Walt Disney 34.39 6.5

HD Home Depot 27.37 4.2

PG Procter & Gamble 70.36 -2.5

CVX Chevron 87.80 -3.9

...and worst performers

Symbol Company name Friday % change, 2008

close

AIG American International Group $3.85 -93.3%

GM General Motors 13.08 -46.3

MRK Merck 31.84 -43.6

BA Boeing 59.76 -30.6

MSFT Microsoft 25.16 -28.5

C Citigroup 20.65 -26.9

INTC Intel 19.23 -26.5

GE General Electric 26.62 -25.7

AA Alcoa 26.79 -25.6

T AT&T 30.43 -24.4

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