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A Time to Let Go Of Overvalued Stock

By JAMES B. STEWART

Last week the Nasdaq topped 2000, a milestone in itself, but also another selling threshold for Common Sense. The Nasdaq hasn't been that high since last Oct. 1, and at that level it was 58% above its March 9 low.

This means it's time—past time, actually—to take some profits. The Common Sense system calls for selling at intervals of 25% gains in the Nasdaq, but there are no hard and fast rules. Even with this week's modest market pullback, we're still in selling territory. The Common Sense goal is to sell higher and buy lower, not perfect market timing. Anyone who followed my advice to buy stocks last March is sitting on some significant gains. As usual, this isn't a prediction that the market is going to fall, simply a recognition that no market rises indefinitely without a correction and an accompanying buying opportunity. This is the second selling opportunity this year without an intervening correction.

As usual, reaching such a milestone begs the question: What to sell? I find most people (including me) are better attuned to buying than selling. It's especially hard to part with stocks that have had a stellar performance. The simplest approach is to sell those that have gained the most since the rally began last March. But since the rally has become more extended, I screened the universe of U.S. stocks looking for those with both the biggest gains and the highest price-to-growth (PEG) ratios, which are often indicators of over-valued stocks. A high PEG suggests that the price is high relative to the expected earnings; a PEG over 4 is a warning sign.

So I searched for U.S. stocks with a PEG greater than 4 and above-average gains since March 9. Here, ranked by gains, are some of the stocks that turned up: Powerwave Technologies (up 422%), Tenet Healthcare (361%), Cray Inc. (242%), Janus Capital (223%), Starwood Hotels (185%), MeadWestvaco (160%), Sothebys (136%), SanDisk (119%), Williams-Sonoma (102%) and LSI Corp. (100%).

I was surprised that they were such a varied lot, from auctioneer Sotheby's to paper company MeadWestvaco to hotel and resort operator Starwood. If I owned any of these, I would be grateful for the big gains and start taking some profits. Since I don't, the list didn't do much for me.

So I looked at high PEGs, without regard to how the stocks performed during the rally. Quite a few energy companies made the list, including Exxon Mobil (PEG of 18), Halliburton (36), Smith International (5), Hess, (6.4). (I own Smith.) As a group,

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energy stocks seem to have gotten ahead of earnings expectations, suggesting they're due for a pullback.

There were quite a few financial companies, too, including [SVB Financial Group](#), which I recommended (and bought) last year as one of the banks likely to survive the financial crisis. (SVB now sports a PEG ratio of 10 and has gained 208% since the March low.) There were also a lot of real-estate investment trusts, which, if I owned any, I would sell in anticipation of further deterioration in commercial real-estate markets.

I suggest going through your portfolio, checking the PEG ratio on stocks you own as well as their recent gains. PEG ratios are hardly infallible guides to future performance, so I'd treat them only as suggestions for further analysis. But they do provide an objective measure of valuation, rather than relying on your gut feelings.

As usual when reaching a selling threshold, the important thing is to sell something that you think is overvalued relative to the broad market. If you don't want to part with any individual stocks, you can always sell an index fund.

And you may well want to sell or reduce some international positions as well. Many international markets have done even better than the U.S. this year. Two of my best-performing positions have been the [iShares MSCI Brazil Index ETF](#), which has nearly doubled, and the [Market Vectors Russia ETF](#), which has more than doubled since March 9. Selling positions that have gained disproportionately is also a good way of rebalancing your portfolio—a useful exercise at any time, but especially when we're at a selling threshold.

I hope you've been enjoying the rally. If it keeps going, great. But at some point there's going to be a correction. Then you'll be glad you're sitting on some cash.

Corrections & Amplifications

Parker Hannifin Corp. is a diversified manufacturer of motion and control systems. A previous version of this column incorrectly identified Parker Hannifin as an energy company.

James B. Stewart, a columnist for SmartMoney magazine and SmartMoney.com, writes weekly about his personal investing strategy. Unlike Dow Jones reporters, he may have positions in the stocks he writes about. For his past columns, see: www.smartmoney.com/commonsense.

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