Sell Discipline: The Art of 20/20 Hindsight

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If we all had a crystal ball and were able to see what the future holds, buying and selling stocks would be easy. However, until time travel becomes a reality, the future will always remain uncertain. We often get the question from clients "when is the right time to sell a stock?" In theory, investors are supposed to buy low and sell high. In practice, this is often difficult to do. How do you know when the stock has reached "the high"? In theory there are no ceilings to how high a stock price can go. When you are making the initial purchase presumably you think you are "buying low," (if not why else would you buy it?), but stocks can go lower, and in theory to zero. Many investors hold onto their losers too long, not being able to admit their initial investment thesis was wrong. Others sell their winners too early, capturing gains before the earnings growth of the investment really kicks in, leaving further returns on the table. However, there are many components to this seemingly easy question of when to sell, and the most popular answer is…it depends.

Selling depends on what the investment time horizon is for that particular investor? Does the investor need cash flow today? What happens to the income stream of the portfolio if that investment is sold? What type of account is the position being sold out of, taxable or tax exempt? If taxable, and a gain, has the investment been held for longer than one year? By selling this security has the balance of the portfolio between equities and fixed income been skewed to one side? Has gifting the stock been considered, as opposed to a sale? These are the initial portfolio questions that need to be answered before selling out of a position.

On an individual stock basis, there are four main questions that must be considered: First, has the stock become expensive? Second, is there another investment with a better risk/reward scenario? Next, has the original reason for investing in the company been called into question? Finally, has the stock appreciated and become too large, now posing concentration risk to the portfolio?

1. **Has the stock become expensive?** Is the market currently offering too high of a price to participate in the future profitability of the company that may not actually occur? Have market expectations exceeded the actual earnings fundamentals of the company (think tech stocks in 1999, or solar stocks in 2007)? When we buy a stock we are looking for solid earnings growth at a cheap price. In other words, we are looking to buy a Ferrari, but want to pay the price of a Ford. When the market realizes that the Ford is actually a Ferrari, is the time to sell.

2. **Is there a better idea?** A company has executed on its earnings growth targets and the stock price has responded in kind. Because the stock has been a strong

performer, and the market is now "convinced" of its future prospects, the stock may not be good value going forward. We then ask, is there a better investment opportunity that is more attractive than the present holding over the next 3-5 years? In this case, we would sell the stock with the goal of trying to find better relative value in another company.

3. **Has the original investment thesis changed?** We look to invest in companies with a strong business model that has a solid management team, and trades cheaply. However, over time things change, and so too can the investment thesis. A company could make a terrible strategic acquisition. Or, maybe a key member of the management team resigned. If a stock sells off because the market is nervous about a short term issue, that is one thing, if a stock sells off because the company's business model has been impaired, then investors need to sell and move on.

4. **Has the stock become too large within the portfolio?** We do not want one security dominating a portfolio's outcome. So, if a stock has appreciated to where it is too large within a portfolio, we will look to sell at least a portion of the position. In this case, one of the hallmarks of rebalancing a portfolio on a regular basis is to prevent concentration risk from occurring.

A good example of this is through the defense contractors, such as **Lockheed Martin (LMT).** When President Obama was first elected, the economy was in shambles. One way the president wanted to cut spending was on the defense budget. As a result, all of the defense contracting stocks sold off hard. Savvy investors picked them up cheaply. At the time, the market was focused on short term concerns and not appreciating LMT's $400bill backlog of the F-35 fighter jets. In addition, shares of LMT offered a ~5% dividend yield. As time passed, LMT's earnings grew ahead of expectations despite the headwinds, and its stock price appreciated strongly, so its valuation is less attractive. Disciplined investors have been trimming back.

The day to day movement of the market is out of anyone's control and because of this can cause investors to become overly exuberant, or unnecessarily frightened. Investors must remain disciplined to a process and philosophy. Understanding that the time to buy a stock is most likely when everyone else thinks it's too risky, which is what has made the stock cheap and attractive to begin with. Conversely, the moment the market thinks a stock can do no wrong is the time to sell, again not easy to do when going against the crowd.

Selling a stock is not, nor does it have to be, an all-or-nothing event. Investors can simply "take some money off of the table." A key component to portfolio management is recognizing when the time is to cut back a stock to manage the best risk reward. On the other hand, investors can build into a position, buying into an investment over time, whether through

dollar cost averaging, or following a stock, being patient, watching the market's reaction to news, and buying the dips.

Those that remain disciplined to a process and rebalance their portfolios often, will be rewarded over time. No one gets the market correct on a day-to-day basis. The goal is to achieve returns that are reasonable given an investor's time frame and risk tolerance.