When to sell shares

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These three rules can help you take profits before prices fall.

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The opportunity to invest successfully is within everyone's reach, but it is challenging when elements of the sharemarket could be working against you.

Imagine a life filled with promotions for junk food but no one tells you to brush your teeth. Or a garden where experts told you to plant shrubs and trees but never taught you how to prune. In the sharemarket you are constantly being shown how to plant trees and eat junk food – that's the buy side of the investment equation. What irks me is that no one tells you when to sell. It's my biggest bugbear.

Sharebroker recommendations often travel from 'Buy' to 'Hold' then back to 'Buy', and then all of a sudden 'Ceasing Coverage' appears. Rarely is a 'Sell' mentioned, let alone maintained for any length of time.

You can't buy shares in a business and hold them forever. Business is dynamic and unfortunately many of those listed on the sharemarket are destined to be liquidated, or go into receivership or administration. Companies disappoint operationally, their prospects become less bright, they take on too much debt, pay too much for an acquisition, or their share price simply rallies far above any reasonable estimate of value.

How then can you hold these shares and expect to do well? Irrespective of the price you pay, you will eventually lose money.

Unfortunately in the business of sharemarket research, the emphasis is towards 'buying and ignoring', rather than maintaining a truly effective ranking system. I cover every listed company, daily. I know their financials, their announcements, their buybacks and capital raisings, takeovers and market updates. I rate each according to my Montgomery Quality Rating (MQR) system. Based on my research, there should be a lot more 'Sells'.

Main reasons for selling

Ignoring this important selling part of portfolio management is to leave hanging a very significant step in the investment process. As chief investment officer of The Montgomery [Private] Fund, I will sell a holding for one of five reasons. I will explain three here.

Because I don't use charts or technical analysis, have done away with stop-losses and trend lines, and I am an investor in businesses not a trader of shares, my rules for selling may differ markedly from those who use daily price fluctuations as their cue.

Ideally you should purchase shares in an extraordinary business when the price of its shares offer such an attractive margin of safety compared to an estimate of intrinsic value that, even if the company were to continue operating only as it has done in the past, or improve its economics only modestly, the returns would be more than satisfactory.

The buying decision, therefore, is essential to a great return. Any selling must be conducted with a certain amount of trepidation, particularly when tax consequences are considered.

Aside from being wrong, here are a few reasons I may decide to sell (yes, even the shares of a business I rate highly – an A1 rating):

1) Quality and performance of the business declines

The best businesses – those that achieve an A1 Montgomery Quality Rating – will demonstrate valuable competitive advantages, a high rate of return on equity, little or no debt, strong cashflows and bright prospects. It stands to reason that if a business's quality deteriorates; hanging on to the shares reduces the quality of your portfolio. Review the shares in your portfolio: would they pass the tests suggested above?

Thanks to our disdain for paying taxes, it is common to hang on to shares that have done well. Another reason for hanging on is the challenge of finding a suitably ranked replacement.

But letting go of poor performers is something you must do, and when the value-investing approach is being adopted, don't worry about the tax. You are paying tax because you have realised a capital gain. Holding on to a company of deteriorating quality to avoid paying tax is an inferior strategy and leads to the rather more popular strategy of hanging on until a capital loss can be carried forward.

When the attractive economic characteristics of the company begin to fade, it is time to sell the investment.

2) Intrinsic value of the business declines

Twenty years of market experience has taught me that in the short term, share prices move in almost total disregard for the underlying performance of the business. In the short run, the market prices of good companies can go down and bad companies can go up. But over the long term, share prices converge with intrinsic values.

When management makes an overpriced acquisition, adopts an imprudent capital management strategy – for example, retaining capital at low rates of return or increases the dividend payout ratio at the same that it issues new shares or borrows to replace the cash – or otherwise acts incompetently, it is time to sell. Failure to do so is stubborn ignorance, not wise investing.

So even if the dividend yield looks good, earnings are rising, or there is some other factor that renders the issue attractive on a conventional score, sell when the intrinsic value of the company is falling. This is doubly necessary when the share price is well above the intrinsic value, which is my final suggestion for selling in this article.

3) Market price rises well above intrinsic value

Shares simply cannot continue to outperform the underlying business indefinitely. If they did, JB Hi-Fi would overtake Rio Tinto as Australia's largest listed company.

When share prices rise well above intrinsic values consider selling, or at least reducing your position. You may be tempted to set up some hard and fast rules about when to do this, for example when the share price rises to more than 20 per cent above your estimate of value. I am not as comfortable with this approach as I am with the idea that the appropriate premium depends on the prospects for the company, and therefore its intrinsic value in the future.

Suppose a parcel of shares you own are trading at $50 today compared to an intrinsic value of $40. With no margin of safety, you may be tempted to sell. But what if next year the intrinsic value is expected to rise to $50, then to $65 the year after? Some investors may argue that there is greater uncertainty in future valuations, while this year's is known. If that is your view, then you should sell. Alternatively, you may have more faith in your future valuations and be willing to hold on.

The decision to sell is made easier if the future valuation is not rising sufficiently. Rather than rising from $40 to $50 then $65, your estimate of intrinsic value rises from $40 to $44 followed by $48 the year after. Today the shares are trading at $50. The decision to sell is a simple one. You could be waiting more than two or three years before the value catches up with the current price.

Estimate future valuations for the shares in your portfolio and act accordingly. Are you prepared to wait for the intrinsic value of the company to catch up to the current price?

Even Warren Buffett admits the mistake

For some loyal Warren Buffett followers, selling seems to be the antithesis of his value-investing approach. I assure you that outside of Berkshire Hathaway, Buffett's buying and selling is far more frequent and has been for a very long time. Even the world's greatest investor has admitted that in some circumstances it was a mistake not to sell.

When the market judges a business to be more valuable than the underlying facts would indicate, it is time to sell. And if any of the factors I have listed here are evident in any of the companies in your portfolio, it may be time to instruct your broker to sell the shares to someone who disagrees with you.

In all circumstances, your profits are safer when deposited in the bank rather than an inferior sharemarket investment. Don't be afraid to hold large amounts of cash in the absence of superior A1 investments.

About the author

Roger Montgomery established the boutique funds management office of Montgomery Investment Management and manages the Montgomery [Private] Fund. Roger is also the author of the best-selling guide book Value.able.