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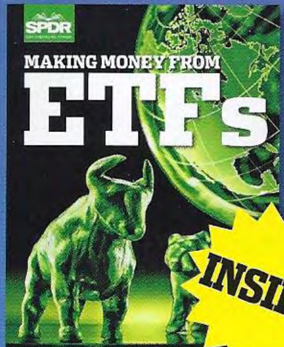

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Is it time to sell shares?

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Is it time to sell?

Roger Montgomery presents a selling strategy

IF YOU TAKE YOUR CUES FROM PRICE rather than values, fear may have recently set in. For Value.able investors, a market correction is a reason for celebration rather than consternation. One should buy shares the same way one buys groceries – the cheaper the better.

At the Montgomery household a hand of bananas is a familiar sight. They're sliced on cereal, frozen for smoothies and blended with yoghurt for Saturday morning pancakes. But at $12.98 per kilo, the Montgomery household is a little less yellow than it was when bananas were $2.99.

Buying shares the way you buy groceries is a surprisingly elegant model and I advocate this approach.

But after buying bananas, they are eaten. Hold onto them too long and you will have gained no benefit from their purchase. The same thing can happen in shares. So when should you sell? It's a topic not frequently discussed and "SELL" is not a brokers' frequent recommendation.

When to sell is a subject that deserves more attention. If you want to achieve extraordinary returns you cannot hold shares in businesses forever. And if those businesses are of an inferior quality, time will be your enemy.

So what are the rules for selling? In my book *Value.able* I outline five rules for selling and in today's column I will cover two you are likely to encounter.

The first is when the prices rise significantly. Many investors believe that a 20% or 30% gain in price is sufficient and take profits.

Of course such an approach will avoid any subsequent decline, but it will also prevent you from benefiting from any further price increases.

How does one solve this conundrum?

Simple. Don't take your cue from share prices. Instead, focus on the intrinsic value of the business. If the price rises well above intrinsic value and even above future intrinsic values, the shares are genuinely expensive and profit-taking is in order.

For example, suppose my intrinsic value for Vocus Communications (ASX:VOC) is $2 and the intrinsic value is expected to rise by 20% per annum for two years. In 2013, intrinsic value for Vocus will be $2.88. If I purchased the shares at $1 and today they sit at $2.20, it is clear that, despite a 120% gain in the price, they are still not expensive.

Focusing on intrinsic value, the way we calculate it in Value.able, provides an anchor in an otherwise tempest-like market.

On the other hand, if the price of the shares is not truly expensive, then holding is a valid option provided the second criterion for selling is not met.

That second criterion is a deterioration in the business or its prospects. A business that disappoints operationally, takes on too much debt, pays too much for an acquisition, or whose prospects dim, should be sold immediately.

I have previously suggested that a conventional "blue chip" portfolio is detrimental to your wealth. Failing to sell shares may also produce unattractive returns.

Since July 2010 the Value.able Stocks column has uncovered 15 extraordinary businesses. At the time of publication, all but six were trading at large discounts to my Value.able estimate of intrinsic value. That's not the case right now (see table).

In December, I hinted JB Hi-Fi may be maturing. Since that time the share price has fallen, so there is merit in letting go of businesses whose prospects are indeed changing (JB Hi-Fi is still an extraordinary business).

Finally, many investors hold on to shares, even in companies of deteriorating quality, to avoid paying tax.

This inferior strategy leads to the rather more popular strategy of hanging on until a capital loss can be carried forward.

Sell businesses whose competitive advantage is eroding, return on equity is declining, debt is rising, cash flow is deteriorating or whose prospects are becoming less bright. But never rush. If you own a piece of an extraordinary business, take the time to calculate the future worth of the shares in your portfolio.

They may be expensive today, but in three years time if the company is forecast to be worth twice as much as it is today, holding on may be the wiser decision.

WHERE THEY ARE NOW

COMPANY	ASX CODE	MQR[1]	EDITION	PRICE AT EDITION[2]	INTRINSIC VALUE	PRICE NOW[3]
Oroton	ORL	A1	Jul '10	$4.00	$8.96	$8.22
ARB Corp	ARP	A1	Aug '10	$5.67	$6.94	$8.09
Carsales	CRZ	A1	Aug '10	$4.99	$3.55	$4.67
CSL Limited	CSL	A2	Aug '10	$33.64	$26.49	$34.21
WorleyParsons	WPL	A3	Aug '10	$23.03	$15.21	$45.07
JB Hi-Fi	JBH	A1	Aug '10	$19.39	$19.54	$18.20
Realestate.com	REA	A1	Aug '10	$10.29	$8.63	$13.25
Cochlear	COH	A1	Aug '10	$71.29	$47.04	$80.78
Monadelphous	MND	A1	Aug '10	$13.68	$14.47	$19.31
Fleetwood	FWD	A1	Aug '10	$9.83	$9.36	$11.37
Decmil	DCG	A2	Oct '10	$2.40	$2.36	$3.23
Forge	FGE	A1	Oct '10	$4.00	$8.96	$6.23
Matrix C&E	MCE	A1	Oct '10	$4.95	$11.13	$8.56
Maca	MLD	B3	Dec '10-Jan '11	$1.46	$2.99	$2.33
Vocus	VOC	B2	Apr '11	$2.62	$1.74	$2.50

[1]Montgomery Quality Rating [2]Share price as in magazine edition. [3]Share price as at 13-May-11

Roger Montgomery is a portfolio manager at Montgomery Investment Management. His book, Value.Able *is available at www.rogermontgomery.com.*