Back to Contents

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ValueLine: Time to sell?

By Roger Montgomery

PORTFOLIO POINT: Investors who have enjoyed the market's sharp rebound might be thinking about taking profits. Here are four points to consider.

I have long held the view that if a company showed no deterioration in financial performance or position and its prospects remained bright, there was no reason to ever sell. Now that I am all grown up, I have put away such childish notions.

Still, it should come as no surprise that the vast majority of writing about investing, focuses on when to buy.

Nothing wrong with that, but just don't forget a disciplined selling strategy is an essential part of your investment process because it can make the difference between a good return and a great one.

Unlike the environment that the world's greatest investor Warren Buffett enjoys – a population that is almost 14 times greater than Australia's 22 million – our companies eventually saturate their market and growth slows.

Companies that continue to retain profits when they reach this point, with the aim of diversifying away from their core expertise or in the hope of garnering the market's attention through acquisitions, have a poor track record of maintaining their previous rate of value appreciation and wealth creation.

In such an environment, buying and holding forever is like the man inflating a dinghy in a dried-up lake: he hopes to have fun but he does not. At no point am I suggesting that we adopt the approach of the manic-depressive: buying and selling furiously in the hope of getting into a slightly faster lane.

Rather, I am for turning the stockmarket off and selecting companies at cheap prices with long-term advantages. This approach ensures that returns will at least match the performance of the business and are also likely to exceed the broader market over long periods.

There are, however, four reasons to sell.

■ The first cause for a reassessment is when I am wrong. Unsurprisingly, I am prone to making errors of both omission and commission. The objective is to minimise their frequency and the magnitude of their impact.

As you know I only use the publicly available information provided by a company. But public information comes in many forms. Auditors are pretty conservative these days when it comes to disclosure in the annual reports of public companies.

The information in an annual report – while it is usually

The ValueLine portfolio, as at October 6, 2009

Company	Buy price	Price today	Est value	Margin of safety	Shares purchased	Invested ($)	Capital value ($)	Divs rec	Total return	Total return
JB Hi-Fi	14.8	18.73	21.7	13.7%	845	$12,500	$15,819	0.29	$3,564	28.51%
Cochlear	56.36	65.27	58.7	-11.2%	102	$5,744	$6,652	0.95	$1,005	17.49%
CSL	31.81	32.69	28.99	-12.8%	163	$5,197	$5,341	0.4	$209	4.02%
Woolworths	26.16	29.16	26.7	-9.2%	206	$5,377	$5,994	0.56	$732	13.61%
Reece	17.8	23	13.7	-67.9%	236	$4,209	$5,439	0.33	$1,308	31.07%
Platinum Asset Mgt	4.06	5.42	2.84	-90.8%	854	$3,467	$4,628	0.12	$1,264	36.45%
CommBank	46.51	50.91	51.36	0.9%	215	$10,000	$10,946	0	$946	9.46%
Since July 1										
Security Value										$54,819
Cash Value										$56,635
Total Value										$111,454
Total Return ($)										$11,454.41
Return Invested (%)										23.73%
Total Return (%)										11.45%
All Ordinaries change										18.30%
* Outperformance (I): Outperformance of Invested Portion										5.43%
* Outperformance (T): Outperformance of total portfolio										-6.85%

Under observation

Company Name	July 1 Price	Price Today	Est. Value	Margin of safety	Divs rec	Total return
ISOFT	0.635	0.84	0.19	-342.1%		-32.28%
Amcor	4.79	5.37	2.84	-89.1%		-12.11%

reliable, companies still make all kinds of announcements between the release of those reports that are not subject to the same scrutiny and it is here that information can be mirage-like in its opacity. Moreover, in valuing a company there is little to be gained from taking its temperature today. My job, and yours, is to anticipate its temperature tomorrow. The annual report is yesterday's thermometer.

Typcially, announcements about acquisitions – which can be infuriating in their lack of detail particularly about the price paid, trading updates, and asset sales – can all harbour information that is of a lower standard than that expected in an annual report.

Indeed, it's not unusual to have to wait for the annual report to get a clearer picture of the impact of management's decisions. It is, however, with this information that we must make valuation estimates and if the information is incomplete or, worse, deliberately obfuscating, my valuation will be wrong: I may have paid too optimistic a price. As new information comes to hand it is essential to remain objective, dispassionate and if that information changes your view of the company's quality, prospects or its valuation adversely, this is a time to sell.

■ The second reason to sell is when the grass is greener elsewhere. Australian companies do eventually run out of opportunities for value accretion and another company may offer the opportunity to increase in intrinsic value at a faster rate. (Alternatively, another company may simply offer much better value.)

In these circumstances a sale is overdue and "greener" grass is offered by the shares of another.

Buffett's sale of Johnson & Johnson – a good company — to participate in the special issues of Goldman Sachs and General Electric is an example of this kind of selling. If you recall, Berkshire Hathaway sold off the pharmaceuticals giant to participate in refinancing exercises at both Goldman Sachs investment bank and the General Electric conglomerate during the depths of the global financial crisis.

Earlier this year, I too sold a swag of shares in one company to buy shares in several others for the fundamental reason that the company I sold was first, far above its intrinsic value, and, second, those that I replaced them with were demonstrating superior performance, had superior management and displayed superior value.

■ The third reason to sell is when the company in whose shares you are invested have simply rallied too far beyond intrinsic value. This is a relatively recent revelation for me.

As I said, I no longer believe you can hold on to stock simply because there are no problems within the company operations; there are stock issues independent of company operational issues that can make a big difference.

It was my contention at the time that when Coca-Cola was trading at 50 times earnings, Warren Buffett must have been champing at the bit to sell. Indeed, he later declared he had made a big mistake not selling in the great bull market. Years later, Coke trades at a substantially lower price.

My sale of The Reject Shop from the ValueLine portfolio a few weeks ago – a company whose shares I first acquired in 2004 at $2.40 – is a closer-to-home example of this third reason for selling. I sold The Reject Shop not because I believe that the company's opportunities are drying up; indeed earnings are heading in the right direction, as are dividends. There is only modest debt and the company has many more stores to roll out.

The reason for selling at near $14 was primarily that the shares were trading at a near 25% premium to their valuation of $11.27. Today The Reject Shop trades at $12.69.

■ The final reason for selling is an observed deterioration in any of the factors that caused one to acquire the shares in the first place. If the outlook for the company's prospects change adversely or if management act in away that does not reflect a shareholder orientation – for example, they grant themselves excessive options, pay themselves a salary beyond their ability, engage in nepotism or make dumb capital allocation decisions – then a reason for selling is triggered.

Alternatively, if like me, you value companies by following Buffett's suggestion of paying a multiple of equity based on the performance of that equity and how it is retained and distributed, then clearly any deterioration in return on equity, or equity itself, any increase in the required return as a result of a weakening financial position or rising interest rates or any change to the payout ratio could adversely impact the valuation. A decline in the value of a company could be a cause for sale.

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So, the truth is that there are plenty of good (and plenty of bad) reasons to sell, but it really should be a last option. An investor paying company tax who makes 15% a year for 25 years by buying and holding will be worth more than double another investor who makes 15% per annum but turns over his portfolio each year. Tax is the fox sniffing at the hen house, and selling lets the fox in. Don't sell unless you must. ◆

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