Deciding When to Sell a Holding

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Three situations that would warrant selling a holding

- There is a need for the money
- To protect a portfolio with a defensive strategy
- To enhance a portfolio with an offensive strategy

Situation 1: There is a need for the money

- A family may need money to make a significant purchase, such as a house or car, or send a child to college
- Money may be needed in a medical or other financial emergency
- For a club like NBN, money may be needed to cash out a member who wishes to leave

Situation 2: To protect a portfolio with a defensive strategy

- NAIC’s “Rule of Five”
- Optimistic/Pessimistic Views
- Characteristics of the defensive strategy
- What to look for with the defensive strategy
- What to do if a decline is detected

NAIC's "Rule of Five"

- For every five stocks picked, one will exceed expectations, three will perform as expected, and one will dissapoint
- This rule applies if proper homework has been done, researching the stock conservatively
- Supported by nearly half a century of NAIC data

Optimistic/Pessimistic Views of the Rule of Five

- The optimist says “For every 5 stocks I own, four will perform satisfactory, and one will perform great”
- The pessimist says “For every 5 stocks I own, one will perform poorly”
- The defensive strategy focuses on the stocks that a pessimistic would worry about

Characteristics of the defensive strategy

- The objective of this strategy is to prevent damage to a portfolio by companies who fail to perform up to a satisfactory level (usually 15% by NAIC guidelines)
- The strategy deals with quality, not value
- Sales, earnings, and profits should be the main points of interest

What to look for with the defensive strategy

- Examine the sales, earnings, and pretax profits each quarter
- Calculate the growth in these areas, referring to the same quarter of the preceding year
- Compare the growth rates with what was expected at the time the stock was purchased
- <u>Take Stock</u> suggests checking sales first, then pretax profits, and finally earnings
- A decline in any of these areas could be cause for concern and warrants a closer look

What to do if a decline is detected

- Identify the length of the period of decline
- One quarter is not enough to know if the company is in trouble; base a decision on at least two quarters
- Give management a chance to make corrections
- Younger companies may show significant growth beyond expectations, then slow down to a reasonable growth rate. Make sure growth is compared to expectations, not historical rates
- Fast declines should be a red flag; consider the momentum of the decline
- Try to identify the reasons for declines in sales, earnings, or profits
- Contact the company's investor relations department if there are outstanding questions
- Sell if the company is found to be in trouble based on the above research

Situation 3: To enhance a portfolio with an offensive strategy

- Characteristics of the offensive strategy
- The role of a stock's price
- Think of it as replacing, not selling
- How to carry out the strategy
- Picking the replacement

Characteristics of the offensive strategy

- The offensive strategy is not urgent or time-critical as with the defensive strategy
- The goal is to enhance the portfolio, not protect it
- The main focus is to decide whether the stock's potential is still good for growth

The role of a stock's price

- When initially looking at the stock, a 5-year estimated price was considered, but that 5-year window constantly moves
- Don't think that just because a stock reaches the initial 5-year price, that it's time to sell
- Also consider the cost of commissions and taxes; taking profits alone is not a good enough reason to sell
- NEVER sell a stock because of price!

Think of it as replacing, not selling

- The first rule of the offensive strategy is to keep what you have unless you find a better stock to put the money into
- This implies replacing the stock, not just selling it
- Replace the stock when it’s overvalued:
  - Risk is greater than the reward
  - 5-year potential is less than desired

How to carry out the strategy

- When initially considering a stock, a pessimistic, conservative bias was used.
- With the offensive strategy, do the opposite and use an optimistic bias to update the TSSW worksheets
- Use an optimistic earnings estimate (not 15% like normal)
- Instead of throwing out the high PEs, throw out the low PEs to calculate the high 5-year price
- Find the stocks that are overvalued with the optimistic recalculations
- Replace these stocks with those with more attractive growth opportunities
- If there are none found that look better, hang on to the stock

Picking the replacement

- Use a screen to find some potential replacements
- Create TSSWs for these stocks, *keeping conservative*
- Compare the following between the current company and the challengers
  - Cost of trading
  - Number of shares
  - Value
  - Projected value
- If a challenger looks better, sell the current holding & buy the challenger!

Comparing the incumbent with the challenger

	Incumbent	Challenger
Cost of trade	None	Commissions + taxes
Number of shares	Current shares held	Value of incumbent / current price of challenger
Value	Shares x Price	Value of incumbent shares – cost of trade
Projected value	PV = Value i% = Total return N=5 Solve for FV in TSSW	Same