Selling decisions- Developing a framework around it

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Words of wisdom from successful investors on Selling decision

“An investor should never sell out of an outstanding situation because of the possibility that an ordinary bear market may be about to occur. If the company is really a right one, the next bull market should see the stock making a new peak well above those so far attained. How is the investor to know when to buy back?

It is my observation that those who sell such stocks to wait for a more suitable time to buy back these same shares seldom attain their objective. They usually wait for a decline to be bigger than it actually turns out to be.”

Philip Fisher

“Only sell to buy a security that is a third cheaper than the stock you currently own.”

“If the stock does not give you 50% in three years, sell it - it’s most likely a value trap.”

Benjamin Graham

Words of wisdom from successful investors on Selling decision

"We sell in the open market when things become grossly overvalued. We are just not that good at selling when things are moderately over priced. We also sell when we make a mistake. Mostly we sell when our companies get taken over. Most of our sales are not to the market. I've been doing this for a long time and I've held securities for three years and sold them after they've doubled only to see them triple over the next six months. When you don't know what you are doing, doing nothing is the best course of action."

Marty Whitman

"Make a clear distinction when selling between 'compounders' and cigar butt stocks." Once the cigar butts get to fair value, it's time to move on, because the cigar butts are "just going to go down again.

Christopher Brown

Even though various investors can have different approaches to selling, It is important to have a framework around selling

Philip Fisher framework on selling

- Investor has made an error in his/her assessment of company
- Company has deteriorated in some way and no longer meets one of the buying criteria that he has define
- Investor finds a better alternative that offers higher long term returns after factoring in capital gain

My learnings/framework on selling so far..

- In the initial part of the journey made selling decisions almost haphazard and no real framework around the same
- However, eventually realized that unstructured decision making around selling has significant impact on return profile
- Started re-reading investment books/investor biographies to figure out the potential structured approach around selling – however found very little information about structured selling approaches
- Thus, I concluded that I need to figure out myself even though it may have shortcomings and framework may evolve only over a period of time

Tenet 1: When I have made mistake in buying

- This is the one of the most prolific reason so far for "selling decisions"
- However, it is also one of the most difficult part psychologically due to
  - Prospect theory
  - Commitment and consistency bias
- However, typically, there has been a lag between realization of mistake and act of selling
  - Lag is because almost every time I tried to collect information/evidence- to refute the realization that I have made a mistake
- Examples
  - Sintex, GSFC, HIL, MPS
  - OCCL- Sold when I should not have

Tenet 2: When Investment thesis is no longer valid

This typically happens in two situations

- When the investment thesis has played out as expected and price-value gap is closed

  This typically happens with

    - deep value/net asset plays – JB Chemicals
    - Opportunistic bets – Torrent Power
    - Special situations - PTL/Artemius

  - Typical tendency to extend/build onto thesis to justify holding can be counter productive
  - Even if the story is changing, it is better to exit and re-enter with a new thesis to ensure demarcation between old and new thesis.
- When key variables in the investment thesis have changed or are no longer valid (i.e. industry dynamics, regulatory aspects, competitive intensity, capital allocation etc)
  - Hindustan Media Ventures Limited, Mayur uniquoters,

Tenet 3: When expected returns of a position over a period of time appears to be well below threshold of my minimum return threshold

- This is relatively new tenet in the overall framework
- Expected return framework appealed more to me as compared to the idea of selling on high valuation because of
  - It takes a more holistic view of the situation and combines business quality, growth and valuation aspects rather than looking at valuation in isolation
  - However, it also becomes a bit subjective, as one has to factor in future growth and exit multiples of a business both of which are inherently uncertain
- I did one analysis where for many high quality businesses,even if one invests at valuation which captures aggressive business growth for next many years, one will still generate very high compounding returns….hence the idea should to stay put with high quality businesses with decent growth prospects. Exception to this rule: egregious valuation (P/E multiple of 100 etc on normalized earnings)

Link to analys..\Documents\Value Investing\DCF_Undervalues_Good_Businesses.xlsxs

Tenet 4: In portfolio, if the allocation of a single business remains much above the upper threshold of allocation

- Two important principles for having upper threshold of allocation for each position
  - Even though we may feel we have good handle of the business…the predictive power of our understanding can be very limited
  - Risk adjusted returns- even though it may lower return if the winner continues to perform, it avoids blowing off the portfolio if unexpected events/developments happen
- Example: Edelweiss Financials
  - Started with 10% allocation
  - Price rose by 400% in a year, while ex-Edelweiss portfolio generated 25%returns- leading to position size increasing to more than 25%
  - Book is almost opaque for minority shareholder and one has no option but to trust the ability and judgement of the management
  - It is a leveraged play and hence any slip off on quality of asset can have disproportionate impact on bottom line
- However, fine-tuning the same to ensure do not cut the winning position too early and too fast, especially when one has bough quality franchise- Should I do the same had it happened with Bajaj Finance?

Tenet 5: The markets pendulum swings to undue exuberance resulting into market valuations that are more than 2 standard deviations away from the average historical benchmark valuations

- As of now this is a theoretical concept as I have never experienced such market frenzy in my investment journey
  - I am not sure about whether I will be able to pull the trigger when it actually happens
  - Another point to mull over- is it better to act based on anecdotal/qualitative assessment of the market instead of sticking to one quantitative parameter

- I am still struggling to figure out
  - Whether one should sell everything or should hold onto high quality businesses and ride through bear/bull markets

Tenet 6: When there is a very attractive alternative opportunity compared to the weakest incumbent in the portfolio

- Even though this is one of the construct in selling framework, it is important to recognize the reinvestment risk involved in this situation, especially if the business one is replacing is performing as per expectation.
- Few condition needs to be met while implementing this tenet
  - New business has to offer significantly better risk-reward than the outgoing incumbent
  - The outgoing incumbent should be decided based on the lowest rank assigned to incumbent based on a process- that mirrors all assessment parameters used at the time of buying (Business quality, management quality and valuation)
- Examples:
  - Replacing Mayur with ENIL
  - Replaced HMVL with ISGEC

Selling for the wrong reasons can be injurious to the wealth creation

- Temporary overvaluation
- Too sharp rise in price in too short a time: Avanti, diversified NBFCs, Symphony?
- Ignorable/non consequential management actions- which are PERCEIVED negatively –e.g: increase in salary, paying dividend but borrowing money, political affiliation, not distributing cash (for the valid reasons): E.g. Amara Raja; Piramal
- Temporary headwinds for the industry/business- Building material sector
- Genuine mistake from management- which has caused temporary problem but long term impact may be very insignificant in overall scheme of things
- Expected performance from new business initiatives/capital expenditure is not coming as expected and benefit is getting delayed
- Positon is underperforming and is bringing portfolio performance down
- Opportunity cost of waiting out!

How do you all think about selling?

Please share your views