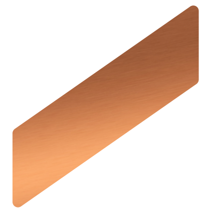


When to **sell**

By Justin Maloney
/ Global Equity Fund Manager

Selling is often assumed to be the other side of the coin, to buying. The presumption is that the decision-making process should be the same. But empirical evidence[1] finds that, for the average fund manager, sell decisions perform less well than (and detract from) buy decisions. Also, those with superior selling skills are also good buyers, but not necessarily vice versa.

Why is selling so hard?

In essence, there are more mental obstacles to overcome. These include:

01 / **Regret (loss aversion)**

The Cambridge dictionary definition of "regret" is a feeling of sadness about a mistake you have made, and a wish that it could have been different and better. Investors typically anchor on the original price paid or to recent peaks. This results in hanging on to losing investments for far too long on the hope of a rebound to the level they wished they had sold with hindsight.

Regret is only made permanent when a stock is sold at a loss. While it is still held there is always the chance (in one's mind) for the investment to recover. Regret also leads to selling winners too early - presumably to avoid the potential discomfort of seeing your gains going up in smoke if the share price rolls over.

02 / **Changing your mind**

John Maynard Keynes famously quipped, "When the facts change, I change my mind." As well as being one of the most influential economists of the 20th century, he was a hugely successful manager of the King's College, Cambridge endowment fund.

However, most people, especially the clever and educated, are afraid to change their minds and admit they were wrong. This is likely exacerbated in a professional context where frequently flagging your mistakes is not an obvious way to self-promote your skillsets. This is true in many fields where a sense of certainty and infallibility provides reassurance (e.g. doctors or airline pilots). It is not, however, the right trait for successful investment analysis, which involves making forecasts over an ever-evolving future.

03 / **Inertia**

For directly held client portfolios, capital gains tax planning (e.g. waiting to sell until the next tax year) can prevent selling. It is not a foregone conclusion that a sale will be successful. By contrast, to quote Benjamin Franklin, "nothing is certain except death and taxes". The problem is that not selling may well cost more in terms of foregone investment returns compared to stumping up a little more to the taxman.

In addition, there are less proactive forms of inertia. The "endowment effect" finds people are more likely to retain an object they own than acquire the same object when they do not own it. The most famous example is a study[2] in which undergraduates were given a mug and then offered the chance to sell it for pens, an equally valued alternative. Once ownership was established the students required twice the mug's value to part with it. This behavioural bias is a problem for investment portfolios as it would stymie switching existing investments into better alternatives.

Inertia is also a result of the uncertainty and the lack of well-defined precision associated with equity investing. An investment thesis will often become less attractive at a glacial pace. This is either because the valuation has become too expensive or because there is a gradual deterioration in the long-term outlook. However, there is rarely an exact tipping point when the investment view switches from buy to a sell. No-one is waving a red flag. The perfect time to sell will only be obvious in hindsight. By that time, it will be too late.

[1] Taffler & Jin, 2016
[2] Kahneman, Knetsch & Thaler, 1990

How do we approach selling?

Our investment philosophy is based around holding a range of high-quality investments over the long-term to best capture the power of compounding. We see ourselves as business owners rather short-term traders of the share price.

As with buying, a clear and repeatable process is also necessary for selling. Our sell decisions need to overcome the behavioural biases described earlier.

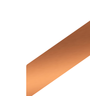
Reasons for selling fall into three categories:

01 / The facts have changed

This is when the original reasons for holding the position have deteriorated. To avoid mission-creep, i.e. changing the original thesis to justify continuing to hold the position, when we first add a stock to the portfolio we document "red flags" that would make us change our mind.

These "red flags" are regularly monitored and provide an objective sell signal. Examples include:

/ Loss of pricing power.
/ M&A outside the core business.
/ Addressable market is ex-growth and reaching saturation.
/ We have lost faith in management.



02 / Competition for portfolio capital

We purposely limit the holdings in the global equity strategy to a maximum of 35 names. The primary reason is to ensure only the highest conviction ideas on our monitored list of 60-80 high quality compounders make it into the portfolio. We want to avoid holding a long tail of less convincing ideas.

Furthermore, because buying is easier than selling (as explained earlier), why not play to this behavioural bias. Our team regular reviews monitored list ideas and new ideas for this list. We are very choosy, so not many make the grade. But when they do that provides an opportunity to think different about an existing position as it is now holding us back from owning a potentially better idea. We consciously seek to overcome the "endowment effect".

03 / Valuation becomes egregiously expensive

A mistake for quality-growth investors is to sell your winners too early. We are aligned with Warren Buffett's shrewd advice that "it's far better to buy a wonderful company at a fair price, than a fair company at a wonderful price". Quality compounders will grow through their valuations. For example, five-years ago Microsoft was trading on a seemingly elevated 30x price-to-earnings ratio. If the share price hadn't advanced since then it would have now been valued at a rock bottom 13x earnings. What had happened was that the valuation stayed at around 30x but the share price tripled, matched by the earnings growth.

However, there is a price for everything (even Microsoft). We do not seek to overtrade on valuation, but we pay a lot of attention and generally take action when they become stretched (two standard deviations away from the mean is a flag for us).

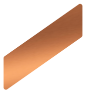
Experience helps

An important selling (and buying) tool is to codify our shared knowledge and experience. To quote George Soros, "To others, being wrong is a source of shame; to me, recognising my mistakes is a source of pride. Once we realise that imperfect understanding is the human condition there is no shame in being wrong, only in failing to correct our mistakes".

Over the years, we have documented our lessons learnt – successes as well as mistakes. We add to this every expanding internal booklet annually. Examples of our selling lessons include:

/ Your first loss on a stock is often the best loss.
/ Management teams are economical with the truth and will hope for the best.
/ Think like a short-trader when considering the bear case.
/ Trim at two standard deviations expensive.
/ Start over with a blank piece of paper.
/ Maintain a wide bench of ideas vying for a place in the portfolio.
/ Large acquisitions = dead money.
/ Big ships are hard to turn.
/ And so on...

This collective wisdom is regularly noted in our investment discussions, shared with the next generation to accelerate their learning curve, and helps avoid repeating old mistakes.



To conclude

Our investment philosophy and process are predicated on selecting only the best compounders and allowing sufficient time for their investment theses to play out. However there will be times when we need to move on. Being humble, understanding our own biases and having the guardrails and processes in place ensures selling is given equal billing to buying.

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