

STOCK STRATEGIES

A Fund Manager's Rules for Selling Stocks

Mastering the art of knowing when to sell can make a big positive difference in your long-term returns.

BY JOHN DEYSHER, CFA

John Deysher, CFA, is president and portfolio manager of the Pinnacle Value Fund, a diversified, SEC-registered mutual fund specializing in the securities of small and micro-cap firms. He has managed equity portfolios for over 30 years. Find out more at www.aaii.com/authors/john-deysher.

Selling is often one of the toughest parts of investing. Do it well, and you can make multiples on your money. Do it poorly, and it will cost you dearly. Buying is always an option, allowing an investor to wait for just the right "pitch." But once you own it, you're committed.

At Pinnacle, we would prefer to hold a position for several years as the price rises on a tax-deferred basis. But sometimes a sale (full or partial) is the right choice. As a wise investor told us years ago, you will never sell at the highest price; try to sell for a "happy price," which provides the satisfaction of a job well done.

Reasons We Would Start to Sell

Generally, there are several circumstances that lead us to start to sell a position.

The Stock Reaches Its Target Price

When we have completed our due diligence on a stock, we assign buy and sell triggers to it. The buy trigger is the price at which we'd like to purchase the stock, while the sell trigger is the price at which we'd like to sell it. Triggers are assigned based on information currently available. They may be adjusted up or down as company fundamentals evolve.

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For example, Universal Stainless & Alloy Products Inc. was a holding of ours that was recently acquired by Aperam S.A. (APEMY), a Luxembourg-based maker of stainless and specialty steel products. We owned Universal Stainless & Alloy Products for a while. We were attracted by its solid market position in stainless steel and alloys, strong balance sheet and capable management team. We visited with management at the company's headquarters in Bridgeville, Pennsylvania, and were excited to learn more about their growing aerospace business as a component maker for Boeing Co. (BA) and Airbus SE. We knew that commercial aviation would do well post-pandemic and bought more shares.

Our initial cost was approximately $7.80 per share, a price that was well below tangible book value. Although the company was losing money amid the coronavirus pandemic, it had a strong balance sheet and was well-positioned for a rebound in commercial airline travel. We thought the shares should trade up to book value—about $24 to $25 per share—when this occurred. We set our sell trigger accordingly and continued to monitor the company's performance.

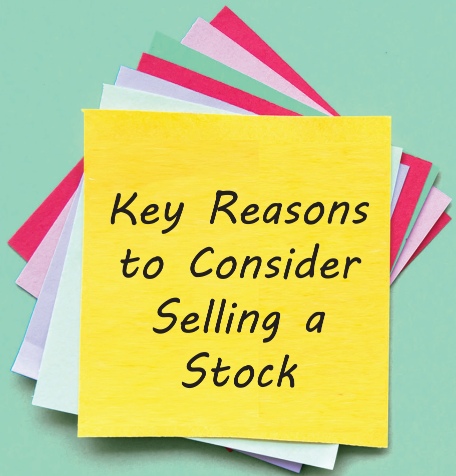
The company's results met our expectations, and we sold some shares to lock in profits while raising our trigger price to reflect the robust outlook. Management continued to execute well, and the company's results improved significantly to near-record profitability. Finally in October 2024, Aperam emerged as a serious suitor looking to establish a U.S. beachhead, and it bid $45 per share in cash for the company.

At this point, we had to decide whether to take the money and run or wait for the acquisition to close in 2025, which would postpone realizing long-term capital gain taxes. Since Aperam is publicly traded, we looked at the company and determined that they had the resources to close the deal and that there would be minimal antitrust issues. Universal Stainless & Alloy Products is a good example of our thesis playing out, where we consistently raised our sell trigger as results improved and sold shares periodically while still owning shares at the time of the bid.

We Make a Mistake or the Fundamentals Change

One of our most painful mistakes involved owning Tidewater Marine Inc. and GulfMark Offshore Inc., which provide offshore supply vessels (OSVs) to service offshore drillers around the world. While aware of industry cyclicality tied to oil and gas prices, we underestimated the extent to which declining oil prices in the fall of 2014 could disrupt the industry. While we thought their debt was manageable, the abrupt revenue decline made debt service problematic, and distress quickly ensued.

While we sold some shares, we should have sold more at the first sign of trouble. We made the mistake of assuming



Your Price Target Is Reached: John Deysher sets a price (a trigger) at which he would like to sell the stock. The trigger is adjusted based on how the company's fundamentals evolve.

You Made a Mistake or the Fundamentals Have Changed: Monitor the financial statements so you can quickly move to sell if the situation worsens.

The Hoped-For Catalyst Disappoints: When the catalyst you hoped would move the stock upward fails to materialize or doesn't have the positive impact you anticipated, it is time to move on.

A Position Becomes Overweight: Pare back the number of shares you own in a stock once its position becomes much larger than your other investments.

Large Insider Selling: When many insiders start selling large positions, it could be a warning sign that something is wrong with the company.

You Find Another Stock With More Upside: Deysher will sell at least some of a stock trading within 10% of its estimated value if he finds a good stock trading at a cheaper valuation.

Management Disappoints: If you sense that you've overestimated the skills of a company's management team, admit your mistake and start to sell your shares.

that the vessel asset values would provide a floor for the share price. This did not take into account how quickly asset values can erode when the vessels are generating minimal revenues and profits. We lost a good chunk of capital by not being quicker to react.

We assumed, like many others, that the companies could weather the storm until energy prices eventually recovered. Ultimately, energy prices did recover, but not soon enough to save the fortunes of the beleaguered OSV and offshore drilling industries.

Financial leverage works both ways, enhancing returns when times are good but diminishing returns during difficult times. The key is to continually monitor debt levels, debt service requirements and access to liquidity so you can quickly move to sell if the situation worsens.

The Catalyst We Hoped for Fails to Appear or Yields Minimal Results

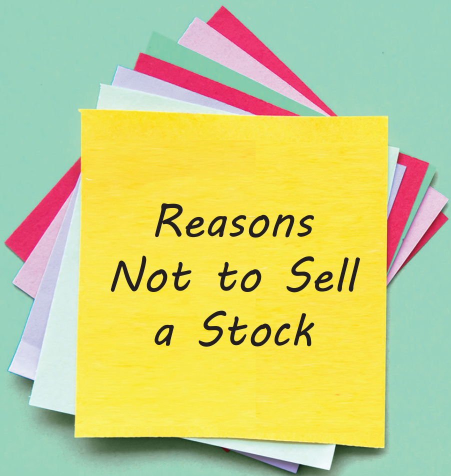
When we buy a security, we generally have one or more catalysts in mind that, upon occurring, will cause the shares to appreciate. Potential catalysts include:

» New management or shareholder base, including activist shareholders;
» Active acquisition or divestiture program;
» New products, distribution or cost-reduction initiatives;
» Initial or increased open market share repurchase by insiders;
» Increased institutional sponsorship; and
» Beneficiary of a cyclical rebound in earnings.

We own a fairly large position in Culp Inc. (CULP), a maker of synthetic fabrics used in furniture upholstery and mattress coverings that is based in High Point, North Carolina. The business is cyclical, tied largely to the housing market, which drives furniture and mattress sales. While Culp made good money during the pandemic when folks cocooned at home with new furniture and mattresses, it has been tough going since. Imports have risen, leading to price competition and lower sales. Culp also made a couple of acquisitions that were less than stellar and overpaid for treasury shares. Finally, Culp's operating footprint across multiple countries turned out to be more than what was needed.

We continue to hold our shares since some catalysts are currently in play. A couple of institutional shareholders now own in excess of 10% each and are likely to keep the pressure on. Culp sold one of the underperforming acquisitions for a small loss. Finally, management has embarked on a long-overdue restructuring that involves asset sales and cost structure rationalization, including headcount reductions.

Fortunately, Culp has a good balance sheet, although net cash has been declining in recent quarters. Also, the firm may soon need to access its credit line to fund the restructuring that will hopefully get them to the breakeven point. So, we'll hold our shares while keeping a sharp eye on the



The Price Drops Because of Volatility: Selling in reaction to a short-term drop in share price can be a mistake if the company's underlying fundamentals remain strong.

Selling Because Others Are: Rather than reacting to what others are doing, base your decision to hold or sell on research, logic and facts.

You Are Impatient With the Stock's Performance: If a stock trades lower after purchase but your investment thesis remains intact, hold on to the stock and perhaps even buy more shares if the value is compelling.

balance sheet and the restructuring. Should net cash begin to be replaced by significant net debt, we'll probably start to sell some shares.

A Position Becomes Overweighted in the Portfolio

We all like to have a major position significantly rise in price, right? While satisfying, complacency toward a major position can lead to serious capital loss if the position moves against you. A large position in a single stock can make your returns dependent on the fortunes of that company. It is better to maintain a diversified portfolio so risk is spread across multiple companies and industries.

Unless we have extremely high conviction in an idea, we'll normally pare a position back once it reaches 4% to 5% of the portfolio.

The Insiders Start Selling in Size

Perhaps no one knows a company's prospects better than the insiders. So, when they start to sell significant dollar amounts of shares, it is worth noting. Insiders sell for a variety of reasons: to fund a retirement plan, pay for a child's/grandchild's college education or make a significant purchase like a home. But when multiple insiders start selling in size, be careful.

We own shares in Daktronics Inc. (DAKT), a maker of electronic scoreboards, signage and video displays that is based in Brookings, South Dakota. While the company is well-managed, the insiders have been consistent sellers at approximately $13 to $14 per share. This price range is well above our cost of $3.40 per share, so we have been happy to follow their lead.

We Find a Better Relative Value Elsewhere

If a stock we own rises to between 90% and 95% of what we think it's worth and another stock we own is trading at 30% to 40% of its estimated value, we'll sell at least some of the former and buy the latter. Doing so provides a much better margin of safety to keep capital loss to a minimum.

We Lose Faith in Management

We try to vet management carefully during our due diligence process, taking into account their education, integrity, intelligence, energy and experience running a public company. Are their interests aligned with shareholders in terms of stock ownership and incentive compensation? Do they treat corporate governance and outside shareholders seriously? Do they run the business as owners rather than caretakers?

Despite our best efforts, we sometimes misjudge the executive team. Interviewing management is generally the last part of our due diligence process. This is when we try to understand the critical issues and how management approaches their operating, strategic and financial priorities. Are they disciplined on sales initiatives, cost structures and capital allocation? Can they prioritize excess cash uses among share buybacks, dividends, debt paydown, acquisitions or growth initiatives? Astute management is critical for small companies. If we sense we've made a mistake in assessing their skills, we may sell some shares. Poor management can destroy shareholder value very quickly with bad decisions.

Other Thoughts on Selling Stocks

Besides these guidelines, there are other factors that can influence the decision to sell, or to buy more. Here are some of the more common scenarios.

Price Declines

What happens if you buy a stock and it declines in price? Do you sell? The answer is: It depends. If the cause of the decline was something that causes you to negatively alter your fundamental outlook, it is probably best to sell. Even the best investors make mistakes. The important thing is to learn from them and move on.

However, if it's just Mr. Market knocking your shares down and you have conviction about your idea because you've done your homework, then perhaps you should use the opportunity to buy more. Do a quick sanity check to make sure there's nothing else bothering the shares. Some of our biggest winners have been ideas where we had the courage of our convictions and were able to buy more shares at lower prices.

We like to buy stocks as we do groceries—when they are on sale.

What About the "Tweeners"?

Some investors will say, "Never hold what you wouldn't buy at today's price" or "If you own a stock but wouldn't buy it at today's price, sell it." This is ridiculous. When you buy a stock, always have a price in mind at which you would be a seller. If you're right and the shares start to appreciate, let your profits run. The stock is now a "tweener," as it appreciates between your buy and sell prices (triggers). The vast majority of stocks in our portfolio are tweeners—too high to buy and too low to sell.

Taxes Matter

You've heard the saying, "You never go broke taking a profit." While that may be true, you want to take profits on a tax-efficient basis. Taxes are generally lower on long-term capital gains than on short-term capital gains.

So, keep an eye on your holding period and try to extend it to one year or more in order to qualify for lower long-term gains tax rates. Of course, if the market makes you an offer you can't refuse and there's a good chance the shares might fall, it is better to sell now and worry about the taxes later.

Scaling In, Scaling Out

Once we've accumulated a position in a stock, we'll normally try to scale in, or purchase shares over time. We rarely pay the lowest price initially, and scaling in allows us to build a position at a reasonable price. The same holds true for selling. Unless the market offers us an irresistible offer or we discover we're completely wrong, we will typically sell over time to capture a reasonable average price.

We also make extensive use of limit orders on both the buy and sell sides, which keeps us disciplined on price.

When Not to Sell a Stock

Many investors, especially those new to the market, often make decisions based on short-term emotions or external pressures leading to bad outcomes. Try to avoid the following actions.

Reacting to Short-Term Market Fluctuations

Investors often react poorly when the stock price temporarily drops due to market volatility or external factors. Selling due to short-term volatility can be a mistake if the company's underlying fundamentals remain strong. Always focus on the long-term outlook.

Following the Crowd

This usually occurs when an investor sells because others are selling or because of negative market sentiment. Following others often leads to poor decisions since selling under pressure or fear may cause an investor to miss out on a potential recovery. It is always better to make rational decisions based on research, logic and facts. As Warren Buffett says, "Be fearful when others are greedy and greedy when others are fearful."

Giving Up Too Quickly

Wall Street is a place where the patient take from the impatient. Stock market success rarely happens overnight. When you have done your due diligence and established a position at a reasonable cost, be patient as the results unfold. Often, the stock may trade lower after you bought it. If the investment thesis remains intact, hang in there and perhaps buy more shares if the value is compelling. If something has changed, revisit your thesis, but don't automatically sell just because the shares dipped lower.

When you have done your due diligence and established a position at a reasonable cost, be patient as the results unfold.

Conversely, when your thesis is correct and the shares move up, don't be too quick to sell. Continually monitor the company's results. If they continue to improve, adjust your sell price higher. When doing so, be mindful of momentum players who enter the market when a stock has done well and bid the share price even higher.

Develop a Disciplined Approach to Selling a Stock

If you wish to make money consistently, you must develop the ability to sell. It is not always easy, especially if the stock is trading at a loss. Set your personal guidelines for selling, and discipline yourself to sell without emotion. Limit your losses and let your profits run. Mastering the art of knowing when to sell can make a big positive difference in your long-term returns. ■

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