Stock Strategies

Parting Company:
4 Rules for When to Sell

By John E. Deysher

One of the most common questions I get as an investment advisor is "When do you sell?"

It's not an easy question to answer.

Selling is one of the toughest parts of investing. Do it well and you can make multiples on your money. Do it poorly and it can 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.

The situation is similar to that of the chicken and the pig who were trying to decide what contribution to make to the annual farmhouse charity event. The chicken stated "Let's offer them ham and eggs!" The pig replied, "Not so fast. For you that's an option, for me it's a commitment."

Four Rules

I would prefer to hold onto a position for several years. But sometimes a sale (full or partial) is the right choice.

Generally, there are four circumstances when we'll sell a position:

1: The stock reaches its target price.

Whenever 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, and the sell trigger is where we'd like to sell it. Triggers are assigned based on information currently available and may be adjusted up or down as company fundamentals evolve.

For example, in spring 2004, we completed our work on United Retail Group (URGI), a retailer of women's plus-sized fashions through its network of Avenue stores. At the time, United Retail was having problems—operating losses, management missteps, comparable store sales declines and a key executive departure. The shares had fallen from $10 to $2 in two years. However, we liked their strong balance sheet, big potential operating leverage, significant insider ownership and a founding CEO (and largest shareholder) who was returning to day-to-day operations. We assigned a buy trigger of $2.50, which represented a substantial discount to tangible book value and potential earnings power.

Fortunately the shares were trading around our buy trigger and we were able to accumulate a reasonable position. We set our initial sell trigger at $5, which if reached would have given us a double. Well, it wasn't long before the CEO began delivering as promised and comparable store declines became comparable store gains. Black ink replaced red, and by spring 2005, United Retail shares leaped to our sell trigger of $5. We hadn't sold a share.

At that point we took off our "value" hat and put on our "growth" hat. While the shares might no longer look cheap to a value investor, they might look cheap to a growth stock investor now that earnings were finally materializing. Our job at this point was to figure out what a growth stock buyer might pay for United Retail's anticipated earnings stream now that they were beginning to fire on all cylinders.

We did some quick calculations and figured United Retail might eventually earn $1.60 a share. Applying a conservative price-earnings multiple of 10 would yield a $16 share price.

So, we adjusted our sell trigger to $16 a share.

Our thesis and calculations proved correct. By spring 2006, United Retail shares were trading at $18 a share. We began selling prior to that and eventually sold our entire position at $15 to $16. This was a situation where we were successful in "buying value" and "selling growth."

We would have left substantial gains on the table if we'd stuck to our original sell trigger of $5.

Lesson: You can make multiples on a stock as it transitions from value to growth, so always try to anticipate what a growth investor might be willing to pay.

2: They make us an offer we can't refuse.

Sometimes, if you're at the investment table long enough, you get lucky. We owned shares of a small, well-run Minnesota company, Electro-Sensors (ELSE) for a couple years. We bought the stock for a low $4 a share (equal to cash in the bank, net of debt), even though they had a reasonable business making monitoring and process control systems for a variety of industrial purposes.

The shares drifted sideways for the better part of two years until March 2006 when they jumped to $5. A month later in April, they doubled to $10 to $11. There was no company news. However, a quick look at the Yahoo! message board indicated that on ELSE's Web site there was a minor mention that ELSE sensors could be used in the production of ethanol. Ethanol has been a hot investment topic recently.

Having followed ELSE for years, I knew three things. First, while ELSE made sensors that could be used to process ethanol, they'd never made a push in that area. Second, there were probably other, better-positioned players who were targeting that area. Third, the investor enthusiasm that almost tripled the share price in two months wouldn't last.

We began selling and exited our entire position at $9 to $10 a share. We didn't try to adjust our ELSE sell trigger based on how many sensors we thought ELSE might sell to the ethanol processing industry. Any reasonable number we could come up with was probably already reflected in the stock price. We took the money and ran.

You know what happened next. Investor enthusiasm for ELSE shares diminished as quickly as it arose and the shares are now at $4.

Lesson: When they make you an offer you can't refuse, accept it.

3: We make a mistake.

When we buy a security, we generally have in mind a catalyst(s) that, upon occurring, will cause the shares to appreciate.

Potential catalysts include the following:

- 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 repurchases by insiders;
- Increased institutional sponsorship; and
- Beneficiary of a cyclical rebound in earnings.

A couple of years ago we began buying shares of Unifi (UFI) a domestic producer of nylon and polyester yarns, which are processed further into synthetic fabrics used in apparel, home furnishings and vehicle interiors. The company had been hurt substantially by the migration of synthetic fabric production to low-cost offshore locations. Many domestic competitors had exited the business, closing plants and laying off workers.

However, Unifi had a solid balance sheet, a non-union workforce, a modern network of plants and one of the best brands in the business. New management had been hired with a mandate from the board of directors to restore profitability, even if the end result was a smaller company.

Over the next couple of years, new management took many of the above actions. They reduced costs, sold unprofitable businesses, acquired businesses that fit well strategically, gave up unprofitable sales and managed the balance sheet properly.

Unfortunately, things didn't get better. Customers continued to purchase offshore and cost reductions were offset by declines in sales. Key end-user demand from industries like upholstered furniture and auto interiors began to fade as higher interest rates took a toll on home and auto sales. A new low-cost joint venture in China got off to a slower than anticipated start.

In short, although many positive catalysts occurred, it wasn't enough to restore profitability. Our analysis, although diligently applied, was wrong. Although we held the shares for two to three years, things didn't work out as we thought. Fortunately, we bought

Deysher's Four Sell Rules

It's time to sell a stock when:

1. It reaches its target price—however, be sure to adjust the target price as company fundamentals evolve.
2. It makes you an offer you can't refuse—such as a sudden price rise on news that may or may not pan out.
3. You realize you made a mistake—even diligent analysis can turn out to be wrong.
4. You find a better relative value elsewhere—a stock trading at a smaller percentage of estimated value provides a better margin of safety than a stock you own that has already risen and is close to its estimated worth.

Unifi at a low enough price to capture a small profit. But it was a frustrating, time-consuming experience.

When you discover you've made a mistake, see if the position is salvageable and move in that direction. For example, you may decide you still like the company but only at lower prices. In this case, hold your existing position and try to average down. But if your error is significant and you wouldn't have bought the shares initially, it's probably best to sell.

We've sold stocks two to three days after buying them upon learning of a mistake and we've rarely regretted it.

What happens if the catalysts are unfolding and the earnings are getting better but the share price doesn't reflect it? In this case, we'll hold the stock. Eventually, the share price will catch up with the fundamentals—be patient and wait.

Lesson: It's not a sin to make a mistake, but it is a sin to not recognize it.

4: We find a better relative value elsewhere.

If a stock we own rises to 90% to 95% of what we think it's worth and another stock that we don't own is trading at 30% to 40% of estimated value, we'll sell the former and buy the latter.

Why?

The latter provides a much better margin of safety.

Lesson: Let another investor try to make the last few percentage points of a major price move.

Other Thoughts on Selling

Price Declines

What happens if you buy a stock and it declines in price—do you sell?

It depends.

If the cause of the decline was something that causes you to negatively alter your fundamental outlook, it's probably best to sell. Even the best investors make mistakes. The important thing is to recognize them and move on before the damage is too great.

However, if it's just Mr. Market knocking your shares down and you have conviction about your idea because you've done your homework, 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 at lower prices. We like to buy stocks as we do groceries, when they're 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 in mind a price at which you're 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 Count

You've heard the saying "you never go broke taking a profit."

While that may true, you want to do so on a tax-efficient basis.

The maximum federal tax on long-term gains is 15% and the maximum federal tax on short- term gains is 35%. Which would you rather pay?

Keep an eye on your holding period and time your sale accordingly. Obviously, if they make you an offer you can't refuse and there's a good chance the price might fall, sell now and worry about the taxes later.

Scaling In, Scaling Out

When we're accumulating 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 they make us an offer we can't refuse, or we discover we're dead wrong, we'll normally sell over time to capture a reasonable average price.

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

Conclusion

If you wish to make money in the stock market, you must develop the ability to sell.

It's not always easy, especially if it's at a loss. Set your personal guidelines for selling and discipline yourself to sell without emotion. Limit your losses and let your profits run.

Knowing when to sell can make all the difference. ▲

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