

Know When To Fold ‘Em

Remember the old Kenny Rogers song, *The Gambler*? It featured the chorus, “You’ve got to know when to hold ‘em, know when to fold ‘em, know when to walk away and know when to run.” This was fine advice for a gambler in the Old West, and it also draws many parallels to today’s investing environment. One of the most difficult aspects of investing today is the “know when to fold ‘em” part. How do you determine when it is time to sell a stock? The financial press and Wall Street research seem to be focused on the buy part of the transaction with little attention given to the sell decision. Reports highlighting various “buy” recommendations are common. Yet, in many ways, the decision to sell a stock is more important and more difficult than the decision to buy.

When you are buying a stock the slate is clean, and the future is filled with hope and promise. The sell decision, on the other hand, can be burdened with many emotions. For instance, the decision to sell a stock at a loss can be internalized as failure. People naturally try to avoid negative emotions, which can lead the investor to hold a losing stock with nothing more than hope for a better tomorrow, regardless of the company’s business prospects or fundamentals. Likewise, investors can be tempted to cash in quickly on a successful investment. The joy and thrill of a short-term profit can blind investors to the attractive long-term fundamentals of the company.

Emotions can even cloud the decisions of the most seasoned investors. Many investors experience a real separation anxiety when they think about selling the stock of a well-managed company that has produced attractive returns for several years. It becomes comforting to look at the statement each month and see the name of a respected company with a nice unrealized gain. Remember when it was considered heresy to sell Cisco or General Electric in the 1990s? Both of those companies had been market leading performers for several years. Why would you sell those stocks?

The emotional and irrational tendencies of investors have given birth to a specialized field of study—behavioral finance. It turns out that humans are hard wired to make investing mistakes, and it seems that they are prone to make those same mistakes over and over again. Researchers have identified numerous behavioral tendencies that prey on investors, and many of these potential pitfalls are related to the sell decision.

In an effort to reduce the influence of emotions on the sell decision, some investors establish criteria for selling a stock before they actually purchase the shares. A preestablished selling strategy helps to protect investors from making decisions that are clouded by emotions. As you would imagine, there are as many selling strategies as there are investors. Unfortunately, some of the more popular selling strategies actually exaggerate the investor’s emotional response.

Sell The Losers—Let The Winners Ride

One way to deal with the emotions of an unrealized loss in the portfolio is simply to sell the stock. Then you never have to look at it again. Keep the winners in the account, and sell the losers. This selling strategy evaluates each investment over a specific period of time, i.e., three months, six months, one year. If the return over the holding period is negative, the stock is sold, no questions asked. There is no emotion in the decision to sell, but neither is there consideration for the underlying fundamentals and valuation of the company. You simply bail out if you have a loss. Some managers use this strategy near the end of a quarter to “beautify” the portfolio. When statements are mailed out, there is no sign of the troubled stock that hurt performance during the quarter.

The primary disadvantage of this strategy is that you completely overlook the fundamentals of the company. You might be selling one of the most attractive and undervalued companies available. An excellent example of this potential was brought to light recently. One of our newer clients needed help in piecing together tax information for his 2005 taxes. CornerCap managed his money in the last two quarters of 2005, and another manager was in charge for the first half of the year. As we sorted through the buy and sell transactions of the prior manager, it became apparent that the manager's philosophy was to sell positions that were underwater. We recognized one of the prior manager's sells as a small-cap stock that we also sold in 2005. But, that is where the similarities ended. The investment results were dramatically different.

Both CornerCap and the prior manager purchased shares of Odyssey Healthcare in the spring of 2004. In the fall of '04, Odyssey fell sharply on earnings weakness and reports of a possible investigation into billing practices. After analyzing the facts, we concluded the sell off was excessive, and we added to our position in the stock. The prior manager did not round up at that time but did hold on to his initial position. In March of 2005, approximately 13 months after the initial purchase, the prior manager sold his full position in Odyssey realizing a loss of 51%. Shortly after March, the share price rebounded nicely as earnings growth reemerged and the fear of an investigation subsided. We sold our position in Odyssey in August of 2005 for a total realized gain of 30%. The same stock with slightly different entry and exit points produced dramatically different results. Had we followed the "sell the losers" strategy, we would have been selling one of the most attractively valued, contrarian stocks within our universe of potential candidates.

Stop Orders

One variation of the "sell the losers" strategy uses stop orders to protect against a falling share price. This technique requires placing a stop order below the current share price of the stock. When the market price falls to the stop price, the order is executed. This strategy tends to be short-term oriented and significantly increases portfolio turnover as well as the increased cost that comes with additional transactions. As with the "sell the losers" strategy, you could easily be selling the stock when the long-term prospects of the company remain very attractive.

The stop order strategy does protect you against catastrophic events that might move the share price down sharply. Your position would liquidate if negative-company specific news moves the share price lower. The problem is that catastrophic events are not the only negative influences on the share price. Share prices can drift lower in sympathy with the overall market causing the stop order to execute. If the stock prices later reverse course to close higher, you have captured the loss and are locked out of the share price reversal.

Wall Street Recommendations

Even with the recent scandals, many investors still look to Wall Street for guidance on when to sell a stock. We have written extensively in the past about our concerns with Wall Street research. If you are looking to the Wall Street brokerage firms for selling advice, you have to look very closely. There are very few sell or underperform ratings on the stocks followed by analysts. Why is this true? In order to remain profitable, brokerage firms need to make money on analysts' recommendations, either through increased trading volume or through additional investment banking business.

In the past, Wall Street firms tended to drop coverage of a company quietly, rather than issue a sell rating, which could hurt brokerage firms' chances of developing a future investment banking relationship with the company. However, in a settlement with the Securities and Exchange Commission, brokerage firms agreed to issue sell ratings on a portion of the stocks they cover. In addition, brokerage firms must

publish the percentage of stocks within each rating category. The results show that only around 5% of stocks covered in most Wall Street firms are rated as a sell or underperform. These new requirements have also resulted in superficial sell ratings' being assigned to smaller companies that have limited potential for future investment banking revenues.

Buy and Hold Strategies

Since many investment professionals, including CornerCap, extol the virtues of long-term investing, one way to take emotion out of the sell decision is never to sell the stock. Simply buy the shares and let time work everything out.

The "buy and hold" strategies do solve most of the problems noted with the other strategies. There is no need to worry about the quality of Wall Street research, and you will never have to be concerned about short-term price fluctuations. In addition, buy and hold strategies are tax and cost efficient due to the limited number of transactions. While we prefer the buy and hold strategies to the short-term oriented strategies, the buy and hold strategies also have major weaknesses.

Never selling a stock can lead to dangerous overconcentrations within a portfolio. Examples of the damage over-concentrated positions can cause is found by reviewing the return history of the S&P 500 Index. The S&P 500 Index is a market capitalization weighted index. The larger the market cap of a stock, the larger its weighting within the index. Near the height of the tech bubble, the largest 30 stocks represented almost 50% of the index, and tech stocks alone had a 35% weighting. As the bubble burst, technology stocks dominated the returns of the index. There was a similar effect in 1980, when over 30% of the S&P 500 was weighted toward energy stocks.

The table below compares the returns and volatility (standard deviation) of the S&P 500 Index with the S&P 500 Equally Weighted Index. As the name suggests, each stock in the Equally Weighted Index has the same allocation percentage.

	3yr	5yr	10yr	20yr	Volatility (10 yr Std. Dev.)
S&P 500	17.1%	2.4%	8.9%	9.3%	18.1%
S&P 500 Equally Weighted	25.0%	8.7%	11.9%	10.6%	14.6%

Source: Standard and Poor's

Not only are the returns higher for the equally weighted index, but also the volatility, as measured by standard deviation, is much lower. While tax and cost efficiency are desirable, the goal of most investors is to maximize return and minimize volatility. One of the risk management techniques that we use is to weight each position equally within a portfolio. When a position becomes substantially overweighted in a portfolio, we sell a portion of the shares to bring the position back to an equal weight. The proceeds of the sale are then reallocated to positions that are underweighted. This simple technique provides downside protection by preventing a few holdings from dominating the return of the portfolio.

Fundamentally Speaking

You have probably surmised by now that we advocate a selling strategy that considers the fundamentals and valuation of each stock. We find the most attractive stocks for long-term investments to be those that possess low market prices for the underlying earnings, cash flows and book value. We do not become overly concerned with short-term price movements in the stock, as long as the valuations and prospects for future growth remain attractive. When consistently followed, our research philosophy and portfolio

management process help to minimize the influence of emotions on our investment decisions. This disciplined approach to selling stocks is one of the keys to our success.