Selling a Stock – When and Why

Probably the most popular topic for beginners is *What Stock to Buy and When?* While this is an important topic, a more important one is often less popular: *When to Sell?* This is because while the greater part of our long-term return from our investments in stocks derives from the reinvestment of dividends, much or all of that return can be wiped out if we do not know when to sell if the situation deteriorates and the price of the stock falls, leaving us with a large capital loss.

Since the problem relates to minimising or avoiding capital loss, the easy temptation is to rely only on the price of the stock. However, it is not that simple because prices can often move irrationally, especially in the short term. This means that while we would be protecting capital by selling in the face of a fall in the price of a stock, it could also mean that we were shaken out of our investment in a very good business simply because of some short-term fluctuation in its price. We see this all the time when investors use overly aggressive stop-loss levels to trigger sales that are reacting to merely short term fluctuations in markets.

This is not an argument against stop-loss levels because preservation of capital is arguably the most important objective the investor has, even above the aim of making a strong return on their investments. However, it is a caution against trying to eliminate price risk so severely that it works against the return objective. If we are to sell an investment in our portfolio, we need to take a more global view of the investment.

This global view must begin before we make the investment. Before we buy a stock, we should have a clear idea of how the investment will generate a growing stream of dividends. Dividends are paid out of the earnings of the business, so we need to have a clear idea of how the business we are investing in will increase its sales of products or services over time and how it will be able to maintain or widen its profit margins on those sales.

This is a process of analysis that will take into account many things such as:

- prospects for the world, national and local economies
- prospects for the industry the company is in
- the strength of the company and its competitors
- the bargaining power of the company's suppliers
- the bargaining power of the company's customers
- risks of government intervention or technological disruption

and much more, depending on the situation.

This might be distilled down to some key expectations for how the investment will pay off in terms of an increasing stream of earnings and dividends over time. Thus, it may include such things as:

- new or improved products or services
- efficiencies in production, distribution and service delivery from cost reduction initiatives, application of technology or capital expenditure programs
- expansion into new market segments

The list will vary depending on the investment.

If the analysis of a business has been thorough before buying the stock, it will make it far easier to make a decision to sell, sometimes well before the stock price has fallen to a stop-loss level. In principle, we would decide to sell if what we were expecting to happen, that would lead to growing earnings and dividends, was no longer happening and we could not see the situation being turned around in the near future with any certainty.

It will generally be more than one factor that concerns us when an investment seems not to be meeting our expectations. Some common problems that might emerge include:

- A change in government regulation or taxation
- A change in the long-term economic cycle or the cycle in commodity prices
- Boom conditions in the industry reach an unsustainable peak, such that the risk of readjustment is unavoidable and only a matter of time
- The entry of new and powerful competitors, perhaps with a technology, patent or system advantage
- A decline in the industry due to social, fashion or technology shifts with little prospect of reversal or adaptation by the firm
- Changes in management that weakens the business
- Loss of direction in the business
- Deteriorating earnings per share growth and a decline in profit margins and no clear strategy to arrest the situation
- Growth by acquisition that is not clearly improving earnings per share and is increasing gearing

What this holistic approach to our investments requires is sound analysis that informs our expectation of how the investment will succeed over time and then ongoing monitoring of those expectations. This means a deep understanding of the business we have invested in and is far more than just what is happening to the stock price.

A far more general principle is that we should be constantly assessing each of our investments, not just in isolation, but in comparison to alternative investments that we might switch into if their prospects are significantly better than the business we have invested in. This requires overcoming the inertia that is the easy way out: stay with what we have got because it requires mental effort to change.

While we endeavour to build for ourselves a portfolio of great businesses that we hold over many years, things change and we should always be alert to detect when a situation is deteriorating and act well before the crowd wakes up and drives the stock price down.

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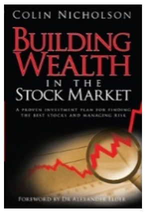

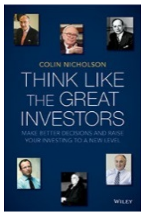

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