When to Sell: Portfolio Management

A Workshop by Ellis Traub
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About the Author

Ellis Traub, renowned financial author and public speaker, is one of the most respected names in the world of fundamental investing. After embracing the methodology behind qualitative growth analysis, he was able to turn his financial life around and has since devoted himself to helping educate other investors.

Ellis is also the author of the popular book *Take $tock* and its companion software, as well as the original developer of the *Investor's Toolkit* line of legacy stock analysis desktop software programs. His company, Inve$tware Corp., merged with ICLUBcentral in 2003. ICLUBcentral's online investing community at StockCentral.com features an online version of Ellis' original *Take $tock* "Instant Stock Analysis" software.

Now retired, Ellis lives with his wife in Davie, Florida and maintains an active speaking schedule and online education presence.

So, What is Portfolio Management?

Although most of the fun of investing surrounds the acquisition of your stocks, the fact is that buying them is only a half of what investing is all about. The other half -- for a variety of reasons we'll discuss in a moment -- is widely considered to be pretty much a drag! Yet, there's as much or more potential benefit is to be derived from managing your portfolio as from buying the right stocks in the first place.

What I intend to do is address all the reasons why we don't do it very well -- if we do it at all -- and to expose those reasons for what they are: insufficient excuses. In the next five lessons, I hope to make it clear that we no longer have a leg to stand on for not doing what we need to do; and, with any luck at all, I might even persuade you it can be as much fun as selecting our companies for investment.

You know, just the term *Portfolio Management* is pretentious... almost intimidating. It suggests that we have to put in hours of dedicated and tedious work, and it suggests that it's much more complicated than it really is. So let's set the record straight here by first understanding what Portfolio Management really is. And the first step to understanding what it is, is to understand what it's not.

Portfolio Management is definitely not Portfolio Tracking. Portfolio management is *not* a process of regularly looking at our portfolios to see how the prices are doing, and whether or not they're making money! Portfolio tracking, at best, is merely checking to see how good or poor a job of managing our portfolios we're doing. It has nothing to do with the actual task of managing our holdings. In fact, as you'll see down the road in this workshop, portfolio tracking can be one of the more insidious things that can work against sound portfolio management.

Portfolio Management is a pro-active activity that requires a certain amount of discipline and dedication. Its purpose is simply to catch our losers before they damage our portfolios' performances, and to maintain our average estimated return at as close to 15 percent as possible so we can meet our objective of doubling our money every five years.

When an issue seems complicated, the easiest way to cut it down to size is to break it down into its smallest parts. In this case, that's easy! Once we own a stock or stocks, there are only two things we can possibly do with them: either hold onto them or sell them. Since we already hold them, we are left with only one decision to make; and that is simply when to sell them. So Portfolio Management is nothing more than making that call: when to sell your stocks.

More than *when* is the issue of *why* we would sell them. As long-term investors, the most important thing that distinguishes us from *the herd* —- those who trade or try to make money in the market in the short term -- is the definition of *long-term*.

We buy stocks not to hold until they reach a target price, not for a month, not even for five years. We buy them to hold forever! That is-— and here is where I can take another step towards simplicity —- unless one of three, and only three, conditions comes to pass:

1. We want or need the money
2. The **quality** deteriorates (Defensive Strategy)
3. The **potential return** deteriorates (Offensive Strategy)

Indeed, these are the only three conditions that would warrant your selling a stock.

So, “When to sell” (Portfolio Management) means watching our holdings to see whether any of them meet conditions 2 or 3 in hopes that we can hold onto them until we reach condition 1.

So, just what is it about portfolio management that intimidates us and keeps us from doing what we need to do? I’ve come up with a little list that I believe covers most of our problems:

- It seems like it’s an overwhelming, never-ending task that is always hanging over out heads no matter what we might do
- The tools for doing it are obscure, the PERT form is complex
- It’s just not much fun and not nearly so exciting as buying new stocks
- We feel no urgency unless the market is down and our prices are depressed
- We simply don’t know what to do

I should think that the first item is the one that affects the greatest majority of us. It’s awfully hard to start a task when you think it has no end to it; and just the fact that it remains undone is enough to give most of us an excuse (lame as it may be) for letting it stay that way.

Until recently, the only tool available for managing our portfolios has been the PERT form. If you’re not really familiar with it, it can be bewildering and appear just too complex. (Of course, once folks realize that only about six of the columns are important at all -— the rest are just the numbers used to calculate the important data —- and that most of the stocks that appear on the form don’t even need to be looked at, it becomes a lot less daunting.)

Nevertheless, it’s an intimidating form; and most of us have shied away from it rather than taking the bull by the horns and diving in when we should. Well, later in this workshop, I'll show you why we no longer need to use the PERT at all! In this day and age, when anyone who has enough money to invest has a computer, there’s no reason to bother with that form, unless you want to print one out for your club or for your own reference. You certainly no longer need it to perform the tasks necessary to manage your portfolio properly.

For most of us who understand how simple the concepts George Nicholson gave us are, and how —- as Peter Lynch has said, “anyone using only 3 percent of his brain can pick stocks as well or better than the average

Wall Street professional" —- all the fun of investing lies in discovery! Finding that new stock is what gives us that rush; and discovering that stock study with a set of railroad tracks on it is what investing is all about.

I submit we can get just as much of a kick out of catching that one out of five that's going south before it hurts our portfolio's performance as we can finding the new ones. Moreover, once we're fully invested, it's the best way I know to keep having all that fun finding and buying the new ones! And, even if you can't be Pollyanna enough to find pleasure in doing it, you'll be happy to discover that you don't have to do it nearly so often as you might think.

As long-term investors, we're accustomed to watching our portfolios with a lot less concern than those who trade or who buy and hope to make a killing. Some of us don't pay much attention to our portfolios until we receive a statement from the broker once a month.

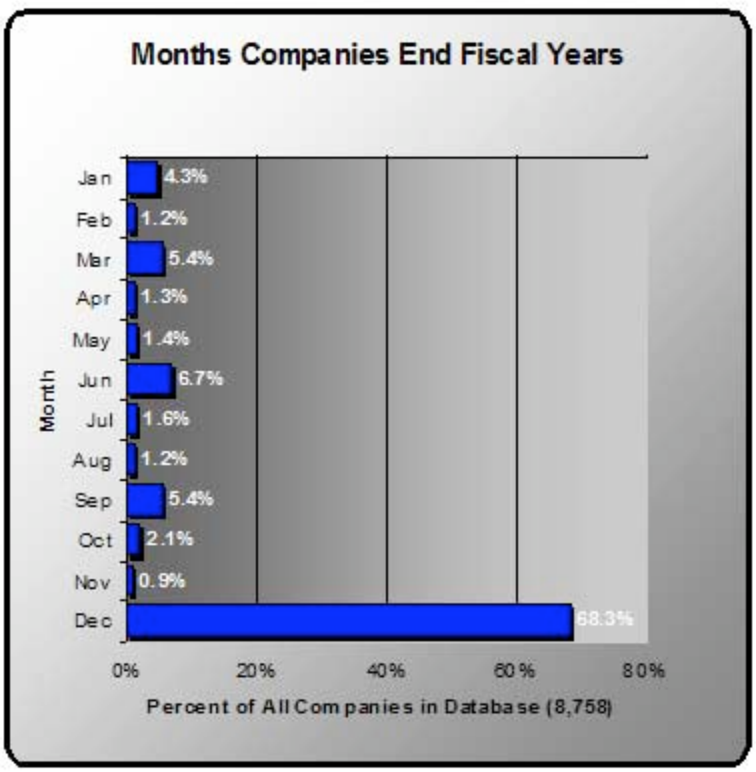
However, it's amazing -- even for us -- just how much attention our stocks suddenly get from us when the market is down. It seems like it's only then that we become concerned about doing something with our portfolios. And all too often, it's the wrong thing.

Those accustomed to tracking their stocks and who "manage" their portfolios by frequently checking on the prices and their effect on the value of their portfolios are the ones who are most likely to suffer. They will watch as the market drags down a stock and, because they're unwisely shackled to the price as a measure of success or failure, will sell because the price has gone down. This is counterproductive and has cost many a would-be investor a lot of money.

The paragon of portfolio management is someone who does her defensive chores on schedule and pays attention to the market only to be delighted that, in a down market, the prices for replacements are low. That same exemplary investor will, of course, take advantage of an up market to find and replace those stocks whose prices are so high that they no longer can produce the kind of return she requires.

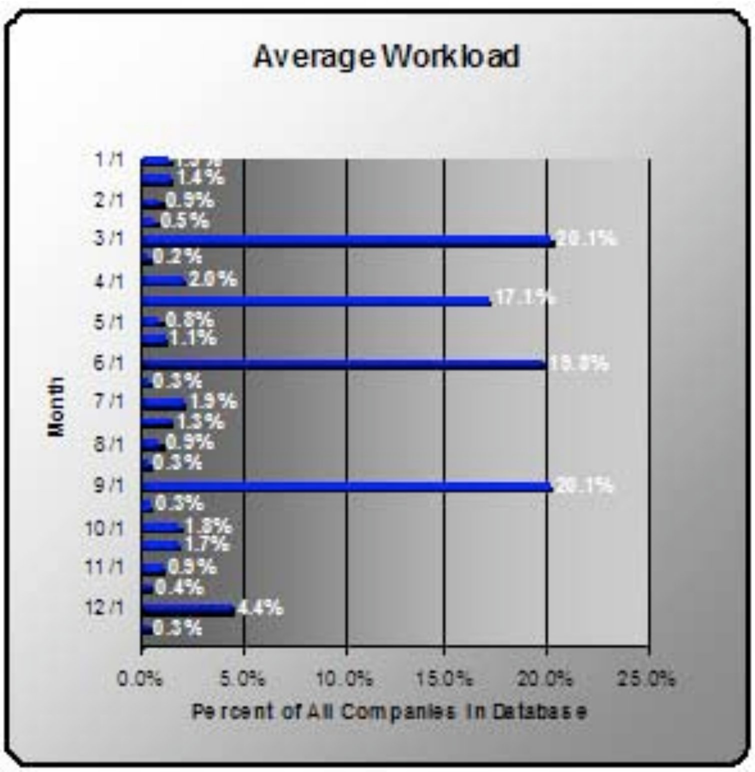
In order to address the first excuse, "it's an endless job, always hanging over our heads," I decided to find out just how little we actually have to do to successfully manage a portfolio. What separates us from the trader or short-term investor is the fact that they must follow the prices of their stocks, and those change every moment the market's open. We, on the other hand, are interested only in the fundamental data that is reported just four times a year.

To address the issue of how much work we must do, I did a study of all the stocks in the databases we use to find out just when they report their financial results and when the data is made available to us. It produced some interesting results:



Note that more than 2/3rds of the companies (68.3%) have fiscal years that match the calendar year, closing their books on December 31st. The next largest group (6.7%) end their fiscal years at the end of June, while 5.4% each end their years in March and September, respectively. The last noteworthy group (4.3%) is the retailers who end their fiscal years at the end of January so as to be able include their holiday business in their financials. The remaining 9.9% are scattered fairly evenly through the rest of the year.

Now, let's consider when the data will be available for us to use. As long-term investors, we don't have the urgency to obtain the data hot off the presses when the companies close their books. All too often, preliminary data changes after being audited or scrutinized carefully; so the data providers prefer to use the data as it has been submitted to the Securities and Exchange Commission (SEC). That agency requires the annual data to be submitted within 90 days of the end of each fiscal year, and within 45 days for the other three quarters. Allowing two weeks for the data to be massaged and published by the data providers, we find that we can plan on the data being available to us 105 days following the fiscal year and 60 days after the end of the interim quarters. With that in mind, let's look at the workload that gives us:



What does this tell us? It means that, for a portfolio consisting of a cross section of companies from the database, we would have only four days a year that would involve a lot of work, since more than 90% of the companies produce financials at the end of March, June, September, and December.

How can we translate that into our own personal workloads (and the ticket to cutting it down)? Using this information, you can easily determine the fiscal year end for each of the stocks in your portfolio. You can then figure when the quarters end. On your desk calendar or in your daily diary, simply add 15 days to each of those dates and schedule your workload accordingly. Here's a portfolio that's fairly typical, so far as the distribution is concerned:

	FY	Data is Available			
Company	Ends	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr
WMT	Jan	1-Jul	1-Oct	1-Jan	15-May
BMET	May	1-Nov	1-Feb	1-May	15-Sep
ACS	Jun	1-Dec	1-Mar	1-Jun	15-Oct
CAH	Jun	1-Dec	1-Mar	1-Jun	15-Oct
EAT	Jun	1-Dec	1-Mar	1-Jun	15-Oct
SCSC	Jun	1-Dec	1-Mar	1-Jun	15-Oct
CSCO	Jul	1-Jan	1-Apr	1-Jul	15-Nov
FDS	Aug	1-Feb	1-May	1-Aug	15-Dec
AMGN	Dec	1-Jun	1-Sep	1-Dec	15-Apr
CECO	Dec	1-Jun	1-Sep	1-Dec	15-Apr
EPIQ	Dec	1-Jun	1-Sep	1-Dec	15-Apr
HDI	Dec	1-Jun	1-Sep	1-Dec	15-Apr
LNCR	Dec	1-Jun	1-Sep	1-Dec	15-Apr
RCI	Dec	1-Jun	1-Sep	1-Dec	15-Apr
SYK	Dec	1-Jun	1-Sep	1-Dec	15-Apr

This, then, is what our datebook will look like:

Date	Companies to Review
1-Jan	CSCO WMT
15-Jan	
1-Feb	BMET FDS
15-Feb	
1-Mar	ACS CAH EAT SCSC
15-Mar	
1-Apr	CSCO
15-Apr	AMGN CECO EPIC HDI LNCR RCI SYK
1-May	FDS BMET
15-May	WMT
1-Jun	ACS CAH EAT SCSC AMGN CECO EPIC HDI LNCR RCI SYK
15-Jun	
1-Jul	WMT CSCO
15-Jul	
1-Aug	FDS
15-Aug	
1-Sep	AMGN CECO EPIC HDI LNCR RCI SYK
15-Sep	BMET
1-Oct	WMT
15-Oct	ACS CAH EAT SCSC
1-Nov	BMET
15-Nov	CSCO
1-Dec	ACS CAH EAT SCSC AMGN CECO EPIC HDI LNCR RCI SYK
15-Dec	FDS

The interesting thing about this is, when you sort it all out, you have only eighteen days during the entire year that you will have any defensive work! And, those eighteen days break down into this:

- **8** of those days, you'll have only **1** stock to review
- **4** of those days, you'll have only **2** to review
- **2** of those days, you'll have **4** to look at
- **2** of those days, you'll have **7**
- **2** of those days, you'll have **11** to consider

That looks to me like you need to schedule only four days out of the year for any real, concerted effort. Unfortunately (or fortunately) one of those big days is April 15th! You will already have been immersed in your finances, so it's probably as good a time as any to keep right on with it and do your defensive chores.

How much time will you have to spend? For the life of me, I can't see how you would be able to spend more than ten minutes on each stock when you're looking at the quarterly data; and a half hour after the end of the year. To be sure, for every stock you find that needs to be researched and possibly replaced, you'll have another that you can see at first glance needs no attention at all. So this will average out.

This means that the total time you might devote to this task (unless you want to make a hobby or an avocation of it) would be an hour a year for each stock. Is that too much to demand of yourself when it means you can meet your goals? And, of course, if it's fun, you might even look forward to it! So far as I'm concerned, there should no longer be any reason why this looks like an interminable or infinite chore. So say goodbye to that excuse!

Yay, Defense!

When we speak of defense, we think of protection from harm or prevention of loss, and -- whether you're at war or on a ball field -- it is the most urgent need.

As far as your portfolio is concerned, those attributes certainly apply. We are interested in protecting ourselves from any financial harm, and protecting our portfolio from any loss. So it *is* urgent; and it should be regarded as critical to our success as investors.

What is it that we're concerned about? Protection from what? While I prefer to regard the venerable "Rule of Five" as a positive thing (the half-full glass, if you will): *"Out of every five stocks you buy, one will do better than you expect, three will do about as you expect, and one will not do so well*!" There are, of course, others whose pessimistic outlook would translate into, "Out of every five stocks you buy, one of them is going down the tubes!" Defense concerns that one out of five that – if you allow it -- will inevitably threaten your portfolio's performance.

When we buy our stocks, we will have satisfied ourselves that the underlying company's track record of consistent and strong sales and earnings growth has a good chance of continuing as it has in the past. We've assured ourselves that the company's management is capable of continuing that growth because they are operating efficiently (no down-trend in profit margins).

As long-term investors, this is our only concern because our investment will grow at the same pace as the company's earnings. So all we need to do each quarter is to find out whether the new information that's now available confirms that the company is continuing to grow as it was when we bought it. If it is, we won't worry about it until the next time data becomes available. What could be simpler?

Our defensive task has absolutely nothing to do with the price of the stock! I'll say it again for emphasis: *Our defensive task has absolutely nothing to do with the **price** of the stock!* It deals with the Quality issues only: earnings growth and operating efficiency. And we can see that on a growth chart (ex: the Take Stock Online TSSW front) at a glance.

Those who don't know any better will want to set a *target price*. We who do know better set a *target return*. The former is a static target and, when you reach it, you're expected to sell. The latter is a moving target. and, so long as you hold onto the stock, as the earnings rise, the price of the stock will also rise (with the dips and spikes caused by those who collectively make the decisions for a capricious stock market). The potential return should remain fairly constant.

Note also that the hypothetical, potential return rises as the price of the stock falls, and vice versa. So, assuming all the fundamental quality issues are sound, your reasons for holding it (or buying more) increase as the price falls. Of course, the reverse is true as well; and we'll talk about that when we discuss Offense tomorrow.

Why don't we want to sell when the price reaches a predetermined value? First of all, you own good quality stocks whose value will continue to increase as the company's earnings increase. You'll always be able to sell that stock at a reasonable multiple of its earnings.

Secondly, what are you going to do with the money you get from the sale? Well, after you've paid a commission for the sale and incurred a tax liability on the gain, you're going to look around for another stock to invest in and pay the commission on the purchase! And what are the attributes you're looking for in the new investment? They're exactly the same as those of the stock you just got rid of! Does it make any sense, then, to let go of it, save the cost of the transactions, and defer the tax liability until later? Of course not!

So, what process should we follow, and what tools do we have to work with? Here's the simple process:

1. **Update the company data.** Since the occasion for our doing this is when new data is available, we need to update the data and create a new stock study.
2. **Review/update the stock study.** Look at the growth chart to see if it looks (at least substantially) as good as it did when you bought it.
3. **Keep it**, if the growth continues at close to the same rate.

If growth has declined significantly:

1. **Check PERT-A (graph) for trend**. Or, if you don't have the PERT-A form available, look at the quarterly sales, pre-tax profit, and EPS data to see if you can spot any kind of downtrend that arouses your curiosity. If you see a small decrease in year-to-year growth (look first at the percentage change between the trailing four quarters and the same period a year ago, then at the quarter-to-quarter change), you might let management have a chance to correct the problem. After all, you went to a lot of trouble to "hire" a management that could handle problems, not just be successful when things are going well. Your first item of business should be to look at sales growth. It is the least likely to change abruptly because it doesn't have the plethora of expenses that can cause such change. And, if you can catch a downtrend before it has reached the earnings line and everyone else has been spooked, you can often save yourself a good bit of money. Next look at pre-tax profits. Again, if you can catch a problem there before the rest of the world is aware of it, you're better off. Finally, of course, you look at the bottom line. If the problem has caused a decline in earnings growth, it's probably already too late to catch it before you suffer a loss. So you should sell as soon as possible, cut your losses, and get your money working again as soon as possible.
2. **Research the Internet for reasons**. Surf the Internet to find explanations for the problem. News items on financial web sites—especially those in which the management has announced their results for the period—will reveal their views of the problem and often tell you what they are doing or plan to do to correct it. Analysts will offer their opinions too. A little common sense is all you need to decide how credible the information is. If the answers make sense to you, then that's great! You can act accordingly. If they are obscure or don't make sense, or you think they're over your head or not credible, when in doubt, throw it out!
3. **Sell if it's a long-term/serious problem.** If you're satisfied that the problem is likely to be a long-term or serious one, then sell the stock without delay and put your money into another company in which you have more confidence. At this stage of the lesson, someone invariably asks, "How many quarters should you give management to correct the problem?" Again, that's a common-sense thing. When you have lost your confidence and begin to doubt, throw it out! Obviously, the less of a departure from the original growth rate, the longer your patience can last. That's why I

prefer to look at the trailing twelve months instead of the single quarter. Only when a single quarter displays enough of a decline in growth to impact the entire 12 months do I get worried enough to dig into the problem and find out what it is.

Note that we no longer consider it necessary to use the PERT form for these tasks. Most stock study reports contain all of the information you need for these decisions, and since the PERT does not make any distinction between those companies requiring attention and those that don't (which makes it very confusing), we will use that form only for its ability to consolidate information and not as a tool for implementing the strategies.

While we don't want to sell our stocks capriciously or prematurely, we also don't want to hang on to those that fall into "that twenty percent" any longer than we must.

Going on the Offensive

The Offensive side of portfolio management is, as you might expect, quite the opposite of Defense. Whether in a war or a ball game, a good defense will keep us from losing; but it takes a good offense to make us a winner.

Offensive tasks have no schedule and can, in fact, be performed any time the spirit moves us. And there is none of the urgency that characterizes the need for defense.

Unlike defense, offense in this context has everything to do with the price of our stocks. And, the higher the market, the more likely it is that you can profit from the effort.

The short-term movement of stock prices, up or down, is caused by the collective wisdom of the universe of investors who make the market; and, as a body, *they have precious little*! Any event — or rumor of an event — can cause the market to move in either direction, especially if that event happens to scare one of the institutional investors who control large quantities of stock. All it takes is for one respected guru to make a move either way, and the rest of the lemmings will follow blindly. So the market moves when people (*not* wizards who can predict the future) conjure up opinions as to what effect any event next door, around the world, or out in space will have on the economy.

We are interested solely in the return we can get on our investments. And, when the market goes up or down for reasons other than a change in the fundamentals (i.e., the operational factors that affect earnings growth), the price of the stock can fluctuate as much as 50% either side of the average PE at which the stock typically sells.

Since the growth of our investment is tied to the company's earnings growth, it represents a steady and slow increase. When the market goes irrationally down, the potential return (if we purchased that stock at that time) would go up. Therefore, down markets are good times to buy more of what we own and are confident about.

However, the best opportunity to be aggressive and pro-active in enhancing the performance of our portfolios is when the market is on the high side. Assuming we're looking to achieve a 15% return on our portfolio. To make it easy to see the point, let's assume all of the stocks we own today are selling for a price that would give us a 15% (compounded, annual) return should they, in five years, go up to our projected high price (calculated by multiplying the forecast high PE by the projected earnings five years out).

What happens if the market raises those current prices substantially? Suddenly, the difference between our current price and the projected high price for each of those stocks has collapsed. Let's say that difference is cut in half. In that same moment, the potential return on those stocks is no longer 15%. It has declined to only 7.5% — hardly a return on our investment that is of interest to us!

At the same time the return fell, the risk rose. And the Upside/Downside Ratio or Risk Index will decrease or increase respectively to the point where there is probably more risk to the investment than there is potential reward. Obviously this is not a healthy scenario either.

We are still looking for a 15% return on an investment that offers that return at a reasonable risk. If, at that moment, we could find a stock of equal or better quality (growth and efficiency characteristics) that had a potential return of 15% and reasonable risk, would it not make sense to sell our stock and put the money into the other so we could make our 15% on that money rather than the 7.5% we would get if you held onto it?

That's precisely what Offensive management strategy is. When we can realize a substantially better return on our money than we can get from a stock we hold, we are wise to replace it. This is what we must do if we hope to achieve and maintain that 15 percent return we're looking for.
There is, of course, a simple, coherent process for doing this:

1. **Update the prices.** As simple as it is to do in the software, we should update our prices every time we start a session. However, if we're not dealing with software and are doing this by hand, we can only update the prices of those stocks in our portfolio. If we're doing it by hand, it isn't difficult to calculate the return and risk based upon the higher price.
2. **Review the stock study** to ascertain the potential return and risk. Look for returns that are unsatisfactory and Upside/Downside ratios of less than 1:1 (Risk Indices of 50% or higher) — the point where the risk exceeds the potential reward. For such companies--

3. **Revise your estimates of earnings growth and forecast PE upward.** This may come as a surprise; but, when we purchased the stock, did we not deliberately set modest estimates to avoid unpleasant surprises? It was conservative to do so; and, since we now own the stock, it's conservative to take steps that would help you avoid selling it prematurely. The odds are that your company was, and has been, growing comfortably above your earlier estimate; and, it is also possible that investors are happily paying a higher multiple of earnings than you chose to forecast they would pay. So, what I do is to split the difference between my modest estimate and what is actually happening. Where I might have capped growth at 20%, and the company has been growing its earnings at 30%, I might estimate earnings growth now at 25%. This will allow me to take advantage of the actual performance and still leave me some room if the growth rate declines. The same logic serves for the PE forecast. I may have estimated it at 25 times earnings, while investors are paying a multiple of 35. I'll set it up to 30. There is a very strong likelihood that the return and risk will fall back into a territory where they are acceptable; and you can continue to hold the stock and enjoy the benefit of superior performance. Just remember, however, that there is now much less of a margin; so you will have to be a little more sensitive to further rises in the price, and their accompanying decline in return and increase in risk. If resetting the growth and PE estimates does not alter the reward and risk potential sufficiently, then --
4. **Replace the stock** with another company of equal or better quality and having a better potential return with less risk. Obviously, it would be a good idea to maintain a "watch list" of stocks whose quality you have determined to be excellent, but whose prices may not have qualified them for purchase. Hopefully, when the opportunity arises to replace those with insufficient return, you will have a good selection to choose from, ready and waiting.

That's all there is to Offense! Simple enough, isn't it.