THE QUESTION THAT TROUBLES US THE MOST

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"Kya lagta hai market (what's your view on the market)?", "Kya karne ka market mein (what should one do in this market)?", "Su levanu (what should be bought)?", "Su lageche (what's your view on this stock)?", "Ketli seat aavse (how many seats do you think will the ruling party win in the polls)?" – these are some of the most common questions that anyone working in the stock markets faces. These questions come from all around your network – ex colleagues, professional associates, prospective candidates / employers, relatives (in-laws included!), and on bad days, even your mother ("the markets fell sharply today, are you all right?"). While these questions are inescapable, one learns, over the years, to dodge them. There are some questions, however, that can neither be escaped, nor dodged. Amongst these, the one that is most difficult to answer is the question that seldom gets asked: "What is a good time to sell?"

A successful investment operation involves three important decisions: what and how-much to buy, how long to hold, and when to sell. While a lot has been written about the first two, the subject of selling has received very little attention, if any. Indeed, a few ground rules for selling have been talked about, namely:

- Change in investment thesis;
- Higher than expected valuations;
- Better opportunities or need for cash;

While these rules sound simple and intuitive on the surface, they are not that simple in reality – especially the first two. In particular, for a long-term investor, for whom selling is vilified as the worst thing possible, these rules are way more complicated than they sound. Let us consider each of the two rules with the help of some examples.

Change in investment thesis

A complete change in investment thesis is easy to identify and act upon. For instance, let's assume that you have purchased a stock as you expect revenues to increase by 12-15% per annum and margins to improve by 100-200bps over a three-year period. However, if revenue declines instead of growing and margins fall instead of rising, then it is probably an easy decision. But then, reality is never that simple. Let us consider the year by year operational performance of a particular business and evaluate a hold/sell decision at the end of each year - against the same expectations of a 12-15% growth in revenues and a 100-200bps margin expansion. Let us assume that directionally, the entire industry that the company operates in performs similar to the company under consideration.

Year 0: This the year that you decide to buy the business basis the following historical performance:

	H1	H2	H3	H4	H5
Revenue growth		38%	21%	16%	19%
Operating Margins	16%	16%	16%	16%	16%
Earnings Growth		34%	30%	15%	34%

Year 1: It's the end of the first year, and the following is the performance of the company:

	H1	H2	H3	H4	H5	F1
Revenue growth		38%	21%	16%	19%	10%
Operating Margins	16%	16%	16%	16%	16%	19%
Earnings Growth		34%	30%	15%	34%	33%

(H represents historical numbers at the point of purchase and F represents the performance in the years after the purchase)

While it has underperformed your growth expectations, it has significantly surpassed your profitability estimates. Let's say that the stock price has moved up by around 18% during the year and the valuation multiple is now 12% cheaper than at the beginning of the year. Would you hold or would you sell? Or would you add to your position? It may be helpful to make a note of your decision before moving forward.

Year 2: It's the end of the second year, and the following is the performance of the company:

	H1	H2	H3	H4	H5	F1	F2
Revenue growth		38%	21%	16%	19%	10%	6%
Operating Margins	16%	16%	16%	16%	16%	19%	20%
Earnings Growth		34%	30%	15%	34%	33%	12%

The company once again underperformed your growth expectations while surpassing your profitability estimates. Only this time, it has significantly underperformed your growth estimates and marginally surpassed your profitability estimates, leading to a soft earnings growth. Let's say that the stock price moved up by around 19% during the year, however, the valuation multiple is still around 5% cheaper than the initial multiple. What would your decision be? Again, it may be helpful to note your decision before going ahead.

Year 3: It's the end of the third year, and the following is the performance of the company:

	H1	H2	H3	H4	H5	F1	F2	F3
Revenue growth		38%	21%	16%	19%	10%	6%	6%
Operating Margins	16%	16%	16%	16%	16%	19%	20%	17%
Earnings Growth		34%	30%	15%	34%	33%	12%	-7%

Tellingly, the company is now underperforming both your growth and profitability estimates. It has been three years of disappointing top-line growth. Maybe you are questioning if the decline in growth in structural. However, somehow you convince yourself that the decline is cyclical and that earnings will recover over the next three years. The company, on the other hand, reports the following performance in the next year:

	H1	H2	H3	H4	H5	F1	F2	F3	F4
Revenue growth		38%	21%	16%	19%	10%	6%	6%	2%
Operating Margins	16%	16%	16%	16%	16%	19%	20%	17%	15%
Earnings Growth		34%	30%	15%	34%	33%	12%	-7%	-18%

What would you do now? With the benefit of hindsight, you may agree that the best time to sell was probably in Year 2. But with earnings growing at a reasonable rate and valuations being lower than that at the time of the initial purchase, would it have been an easy decision without the benefit of hindsight? Maybe not. Now let us add another layer of information - the price movement of the stock of the company under consideration.

Stock price movement since date of purchase, rebased to 100.

Tellingly, even if you had decided to exit in Year 2, the end result would have been a function of whether you exited in the first half of the year or the second half. Further, unless you sold towards the fag end of the first half, you would have witnessed higher prices in most of Year 3 compared to the prices you sold at in Year 2. Thus, even if you were early in calling out a change in investment thesis, you may still not have sold at the best time possible.

Moreover, if the above case was that of a cyclical slowdown and not a structural one, then selling in Year 2 or Year 3 would have yielded the same result in the long term – that of selling off a compounder too early.

Thus, while it is easier to believe that one should sell when there is a change in hypothesis, in reality, it is very difficult to this without regret.

Higher than expected valuations

In 'Predictions, Timing, and Time in Market' (May 2017), we had illustrated how buying some high-quality businesses even at the peak for the financial crisis of the last decade would have resulted in to satisfactory investment results. We had further illustrated in 'Reinvestment Compounders' (April 2018), that in the long-term valuations play a smaller role in determining returns, so long as a company can continue to generate high returns on its re-invested capital. In our view, the impact of valuations is felt higher in either the near-term returns, or in the case of sub-par businesses. Below is the computation that we had presented in the said newsletter:

Figure 5: Comparative Financial Performance of Three Hypothetical Companies

Company	A	B	C
Current Profits	100	100	100
Multiple	25	10	20
Current Market Value	2,500	1,000	2,000
Reinvestment Rate	100%	50%	75%
Return on Invested Capital	25%	10%	25%
Cumulative Dividends	-	660	725
Profits, 10 years hence	931	163	558
Multiple	15	15	15
Market Value	13,970	2,443	8,364
Returns Multiple	5.6	3.1	4.5
IRR	19%	14%	17%

Year	A			B			C		
	Profits	Dividends	Cashflow	Profits	Dividends	Cashflow	Profits	Dividends	Cashflow
0	100		(2,500)	100		(1,000)	100		(2,000)
1	125	-	-	105	53	53	119	30	30
2	156	-	-	110	55	55	141	35	35
3	195	-	-	116	58	58	167	42	42
4	244	-	-	122	61	61	199	50	50
5	305	-	-	128	64	64	236	59	59
6	381	-	-	134	67	67	280	70	70
7	477	-	-	141	70	70	333	83	83
8	596	-	-	148	74	74	395	99	99
9	745	-	-	155	78	78	470	117	117
10	931	-	13,970	163	81	2,525	558	139	8,504
IRR			19%			14%			17%

Source: Tamohara

Thus, for the long-term investor, returns on invested capital and reinvestment rates matter more than the valuation of the stock of the company.

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These are just some of the many examples from the real world of how hard it is to make a decision on what is the best time to sell. More often than not, you are either going to be too soon or too late in the sale decision. How then does one determine the best time to sell?

Well, if we had the perfect answer to this question, it wouldn't worry us so much. However, based on our experience, and the guidance of some great investors, we deduce the following:

- Usually what hurts investors more is being too late in selling a business whose fundamentals are rapidly deteriorating. In the case of selling too soon, the end result is a function of where the cash flows from the sale are re-deployed (at least there is some hope in that case). Therefore, any sharp change in fundamentals of the company should not be ignored.
- In cases where it is difficult to ascertain a deterioration in fundamentals, we draw upon the wisdom of Phillip Fisher (*Common Stocks and Uncommon Profits*):

  > *"In my management of individual stocks over all these years I have followed the same rule, only once having made an exception. If I have a deep conviction about a stock that has not performed by the end of three years, I will sell it. If this same stock has performed worse rather than better than the market for a year or two, I won't like it. However, assuming that nothing has happened to change my original view of the company, I will continue to hold it for three years."*

  We have internalized the above such that if we revise down our estimates for any company for more than two years, then we evaluate selling the position, independent of the price or valuations. Sometimes the lure of the long-term recovery can trap you into holding on to a losing position for decades (for instance: had you invested in PSU banks expecting an eventual recovery in NPAs at the start of the decade, without a system for a forced sell trigger, you would have probably continued to hold on to these companies while missing out on some real compounders).
- Given the difficulty in determining a good sell trigger, it is important to seek a high margin of safety before purchasing an investment. This ensures that an error in judgement or timing will not cost you a large portion of your capital. Thus, spend more time thinking about the company ***before*** your purchase rather than ***after***.

It is important to note here that the above system helps in minimizing the errors rather than eliminating them all together. Like with any heuristics-based approach, this system is not completely fool-proof or scientific. Replacing analytics with rules of thumbs can often lead to hasty and sometimes incorrect decisions. It is for this reason that amongst all the questions that we usually face, this question troubles us the most.

To sum it up, determining a good time to sell is never easy. More often than not, a sale will either be early or late; there will always be some regret. One can follow/develop a heuristics-based approach in order to minimize this regret, although it can never be eliminated completely. Thus, as a public money manager, the toughest decision to make is "*when to sell*".

P.S.

The above system largely works for a money manager that has to meet client expectations at least over a 3-5-year time frame. An individual investor who has a multi-decadal investment horizon need not be acutely worried about timing her sells, as long as she has a robust investment process. For instance, consider a ten-stock equal weighted portfolio that is left untouched for 10 years. Even if 3-4 holdings lose money, the investor will end up with reasonable returns over a 10-year period, as exhibited below:

	Years	0	1	2	3	4	5	6	7	8	9	10
Holdings	Annual Returns	Initial Investment	Year-end Investment Values									
Holding-1	25%	10	13	16	20	24	31	38	48	60	75	93
Holding-2	22%	10	12	15	18	22	27	33	40	49	60	73
Holding-3	20%	10	12	14	17	21	25	30	36	43	52	62
Holding-4	18%	10	12	14	16	19	23	27	32	38	44	52
Holding-5	15%	10	12	13	15	17	20	23	27	31	35	40
Holding-6	12%	10	11	13	14	16	18	20	22	25	28	31
Holding-7	10%	10	11	12	13	15	16	18	19	21	24	26
Holding-8	-10%	10	9	8	7	7	6	5	5	4	4	3
Holding-9	-8%	10	9	8	8	7	7	6	6	5	5	4
Holding-10	-5%	10	10	9	9	8	8	7	7	7	6	6
Total Portfolio Value		**100**	**110**	**122**	**138**	**156**	**179**	**207**	**241**	**282**	**332**	**392**
Cumulative IRR			***10%***	***11%***	***11%***	***12%***	***12%***	***13%***	***13%***	***14%***	***14%***	***15%***

Until next month…

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