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When to Sell

"If the job has been correctly done when a common stock is purchased, the time to sell it is -- almost never."

Philip A. Fisher, Common Stocks and Uncommon Profits, 1958

With the major market indices continuing to reach new highs, some investors are wondering if they should sell their stocks. After all, if prices are high and the holdings have been profitable, why not sell and take the gains?

On Wall Street, the predilection to sell can be especially prevalent. Many brokerage and research firms publish price targets for stocks and recommend selling them once the target has been reached. Other firms routinely recommend moving to all-cash positions based on market, macroeconomic or geopolitical forecasts. Still others view stocks as little more than trading vehicles and move in and out many times over the course of a month, week, day or microsecond, as in the case of high-frequency traders.

At the other end of the spectrum are investors who never sell at all, such as the "Coffee Can Portfolio" discussed in our Third Quarter, 2012 newsletter. In an article published in 1984, author Robert Kirby described a situation where his purchase recommendations were followed but his sell recommendations were ignored. After many years, the result was an odd assortment of small holdings, several large holdings and one jumbo holding of Haloid which "later turned into a zillion shares of Xerox." Kirby, of course, had recommended that Haloid be sold.

In our firm, our analytical work focuses on the underlying businesses of the stocks we recommend for purchase. We think of our clients as part-owners of those businesses and, as long-term investors, we encourage our clients to own the shares for as long as the company's management team is doing its job to increase shareholder value. Given enough time, a company's share price is likely to increase along with growth in its revenues, earnings and dividends.

However, companies can change and industries evolve, and management teams can lose their way. Sometimes better opportunities develop elsewhere. We thought this an appropriate time to review our investment discipline and how we determine when a stock should be sold.

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The information provided herein represents the opinions of David Wendell Associates and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice. It should not be assumed that recommendations made in the future will be profitable or as profitable as in the past.

As an example, we will use recommendations made last October to a client who added some new stocks selected by another investment advisor to the existing portfolio under our management. Capital gains were not a concern for this client and our goal was to improve the portfolio and better position it for continued growth.

Of course, sometimes a client needs to raise funds to purchase a house, pay for a college education or for other personal reasons. Then there is the "sleep well at night" factor which can influence a course of action. In these cases, we look at the fundamental characteristics as well as capital gains and losses, the diversity and composition of the remaining stocks, and other portfolio management considerations.

The decision to sell ideally should be made in conjunction with a decision to replace and improve. Investors who sell based on price targets or forecasts, especially when moving to cash, run the risk of being left behind if prices keep rising or the forecast does not pan out. Taxes on capital gains may be significant, and at some point the investor will have to make the vexing decision of when to get back into the market.

In our example, we reviewed the new stocks to determine which should be sold and which could be kept. We examined the fundamental characteristics of each company, including reinvestment rates, debt levels and quality and financial strength ratings, as well as the trends in revenue, earnings and dividend growth. The table below compares the fundamental characteristics of the companies recommended for sale and those recommended for purchase:

Sell	Reinvestment Rate	Debt as a % of Capital	S&P Quality	Financial Strength
American Express	22%	71%	B+	A++
American Int'l	7	30	B-	C++
Anadarko Petroleum	10	35	B+	A
CBRE Group	26	54	B	B
DTE Energy	4	66	B+	B++
Juniper Networks	4	12	B	B++
News Corp.	*na*	*na*	*NR*	*NR*
Sanofi	3	16	*NR*	A+
TransCanada	0.5	48	B+	B++
Average	**9%**	**37%**		
Buy				
Grainger, W.W.	15%	12%	A+	A++
Flowers Foods	11	26	A-	B+
Novo Nordisk ADR	34	0	*NR*	A++
Panera Bread	21	0	B+	A++
Portfolio Recovery	18	31	B+	*NR*
Sirona Dental	14	6	*NR*	B++
Trimble Navigation	10	35	B+	B+
Average	**18%**	**16%**		

Data: Value Line Investment Survey, Standard & Poor's
NR: Not Rated
na: not available

As can be seen, the companies recommended for sale, as a group, had reinvestment rates at half the rates of the companies to purchase. A company's reinvestment rate is a measure reflecting the amount of retained earnings that management has available to fund future growth. Companies with higher, and rising, reinvestment rates should be able to expand their businesses without taking on debt or selling assets. They therefore should be able to grow at superior rates compared to merely average companies.

The group of companies recommended for sale also had debt levels at more than twice the amount of the group of companies to purchase. High levels of debt can limit or constrain how a company responds to changes in its market or industry, or in the economy as during a recession or financial crisis. Companies with low levels of debt tend to have more flexibility and thus possibly brighter prospects for the future.

Not surprisingly, superior fundamental characteristics tend to lead to above-average growth in revenues, earnings and dividends. The table below compares the historical track records as well as the projected growth in revenues, earnings and dividends:

Growth Rates Per Share

	Last Five Years			**Next Five Years**		
Sell	Sales	Earnings	Dividends	Sales	Earnings	Dividends
American Express	3%	0.5%	13%	4%	9%	9%
American Int'l	- 11	*nmf*	*nil*	*nmf*	*nmf*	*nmf*
Anadarko Petroleum	2	- 46	*nmf*	9	*nmf*	3
CBRE Group	-3	- 8	*nil*	6	11	*nil*
DTE Energy	0	6	2	3	4	6
Juniper Networks	14	4	*nil*	11	13	*nil*
News Corp.	*na*	*na*	*na*	*na*	*na*	*na*
Sanofi	3	7	12	6	3	7
TransCanada	- 3	1	8	4	13	3
Average	**0.6%**	**-4%**	**4%**	**5%**	**6%**	**3%**
Buy						
Grainger, W.W.	11%	15%	18%	9%	13%	9%
Flowers Foods	8	12	21	9	18	11
Novo Nordisk ADR	15	23	31	14	17	16
Panera Bread	18	22	*nil*	13	16	*nil*
Portfolio Recovery	20	21	*nil*	*na*	*na*	*nil*
Sirona Dental	8	24	*nil*	10	14	*nil*
Trimble Navigation	10	7	*nil*	11	19	*nil*
Average	**13%**	**18%**	**10%**	**9%**	**14%**	**5%**

Data: Value Line Investment Survey as of October 2013.
nmf: not meaningful figure
na: not available
nil: none

Over the five-year period from 2008 through 2012, the group of companies recommended for sale grew their revenues, earnings and dividends at much slower rates than the companies recommended for purchase. And over the next five years, their revenues, earnings and dividends are projected to grow at slower paces than the group of companies recommended for replacement and improvement.

Valuations, or price/earnings ratios, are an important consideration when purchasing a stock. A p/e ratio is a measure of how expensive a stock is compared to another stock or the market as a whole, such as the Standard & Poor's 500. An investor who ignores valuations may purchase a fine company but may make a poor investment.

Each month, we perform our internal valuation and fundamental and statistical analysis of the companies we regularly follow. The table below shows, as of October 2013, the price/earnings ratios as well as our near-term earnings estimates and projected long-term earnings growth rates for the companies recommended for purchase. It should be noted that we review each client's portfolio on its own and not all companies are appropriate for all clients:

Buy	Price/Earnings Ratio	Earnings Per Share 2013E	Earnings Per Share 2014P	% Change	Projected Long-Term EPS Growth
Grainger, W.W.	19x	$11.80	$13.60	+ 15%	13%
Flowers Foods	19	1.00	1.15	+ 15	8
Novo Nordisk ADR	18	8.00	9.20	+ 15	17
Panera Bread	21	6.80	7.80	+ 15	16
Portfolio Recovery	16	3.30	3.80	+ 15	15
Sirona Dental	20	2.80	3.40	+ 21	14
Trimble Navigation	28	0.85	1.10	+ 29	19
Average	20x			+ 18%	15%
S&P 500	14	$107.00	$118.00	+ 10	9

Value Line data and DWA estimates as of October 2013.

As a group, these companies have a price/earnings ratio of 20 times, which was higher than the p/e ratio of 14 times for the Standard & Poor's 500. However, in our view this higher valuation was reasonable given the group's overall fundamentals and prospects for the long haul.

At the end of the day, investors are well-served if the job of analyzing a company includes a thorough review of its underlying business and fundamental characteristics -- this holds true for selling and buying. If the company selected for purchase passes muster on all counts, it could be a long time before it needs to be sold. And selling a high-quality, adeptly managed company just to take profits rarely is a viable long-term investment strategy.

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"If you are shopping for common stocks, choose them the way you would buy groceries, not the way you would buy perfume."

Benjamin Graham, The Intelligent Investor, 1949