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INVESTMENT OUTLOOK — AUGUST 2018

The Unspoken Sin of Investing

Many professional investors throughout their careers tend to favor one of the two major styles of investing – growth or value. Growth investors prefer businesses that exhibit high levels of sales or profits growth and are willing to pay a premium to own a piece of the action. Value investors, on the other hand, seek diamonds in the rough, and generally look for businesses with more stable cashflows that can be purchased at a discount to perceived fair value. At any given point in time, one investing philosophy will out-shine the other. Since the market bottom of 2009, growth companies have realized superior stock price returns while value has not fared as well. However, the pendulum does swing.

The statement above addresses popular investing philosophy as it pertains to buying. But what about selling?

For this month's newsletter, I'd like to pass along an opinion piece recently published in the Financial Times, "The Unspoken Sin of Investing is Selling Good Stocks Too Soon," written by Miles Johnson. Often times, investors address their buying decisions with clients but fail to articulate or give attention to how, when or why they sell out of positions. Sitting on one's hands and doing nothing at all is under appreciated and may be the smartest thing an investor can do.

The Unspoken Sin of Investing is Selling Good Stocks Too Soon

By Miles Johnson

The following article was originally published in the Financial Times on August 9, 2018.

A couple of years ago I met a fund manager in London who recalled with dewy eyes how cheap stocks became in late-2008 as the world trembled after the failure of Lehman Brothers. He fondly reeled off the household name blue-chip US companies his fund had snapped up at rock-bottom prices which went on to strongly recover the following year.

When asked if his fund still owned any of these wonderful shares he gave me a puzzled look. He was a value investor, he said somewhat defensively, and had sold all of them after they rallied and became, in his view, expensive. His fund was now filled with

miners, foreign oil companies and all sorts of low-quality junk. Most of the excellent companies he had sold back in 2009 and 2010 have since trounced the wider market, and the performance of his fund.

The investing mistakes that commonly receive the most attention are when people buy something that falls in price and results in them suffering a loss. The second type of mistake people focus on are those of omission, or when an opportunity to buy a great investment is for some reason missed. Far less attention is given to a common mistake that is arguably a greater sin than both of these: selling an investment too early that goes on to perform fantastically well for many years.

The British fund manager John Armitage, one of the most successful, yet lowest profile, stock pickers in the world, described in an interview from 2007 how many of his biggest unforced errors tended to result not from buying bad stocks but from selling wonderful ones far too early.

Mr. Armitage recalled how “I’ve bought stocks that have gone down, and they sear on your soul, but selling winners, that’s the big mistake . . . I have been a very bad seller of shares. I’ve sold lots of winners.”

“Investors confuse rates of return with the potential for absolute gain. You make the mistake of misunderstanding the true potential,” he added.

It is easier to avoid overestimating the potential of a bad business than avoid underestimating the potential of a great one.

Frauds, fads and failures tend to burn out quickly, meaning their weakness becomes apparent over a few years rather than decades. The warning signs are usually clear. Bad businesses burn through cash rather than generate it, meaning they require constant access to fresh capital to keep going. They operate in highly competitive markets with no distinct advantage. They are prone to dilute investors by issuing additional equity or take on increasing leverage without generating sufficient returns on the capital they devour.

The long-term potential of exceptional businesses that compound their value over decades is far harder to spot.

It is a mistake committed by even the greatest investors. In 1966 Warren Buffett bought 5 per cent of Disney when it was a small-cap stock for \$4m, and sold a year later for \$6m for a 50 per cent profit. Disney is today worth just shy of \$170bn and has returned billions in capital to its investors over the years.

Sometimes exceptional companies undergo transformations that were simply impossible to predict. In the 1990s, when the iPhone did not yet exist, there was no way

of forecasting Apple's chances of becoming the world's first trillion-dollar company. In fact in 1997 — a year when Michael Dell said he would “shut it down and give the money back to the shareholders” — Apple appeared far closer to being a bad business than great one.

Many of those questioning Amazon's future five years ago had never heard of cloud computing, while Microsoft had been forgotten as a lumbering dinosaur.

Mr. Buffett's partner Charlie Munger has described how he is perfectly happy to hold on to shares in strong businesses even if he believes they have become expensive.

“Psychologically, I don't mind holding a company I like and admire and I trust and know that it will be stronger than now after many years,” he has said. “And if the valuation gets a little silly, I just ignore it. So, I own assets that I would never buy at their current prices but I am quite comfortable holding them.”

Unlike the fund manager I met in London, who believed it was his duty as a value investor to sell any stock that returned to a normal valuation and buy up rubbish in its place, Mr. Munger recognised that once an investor has acquired something good at a good price they should try and keep hold of it.

His advice in its broadest sense applies to all types of investors, be they hedge fund managers or individual savers who own low-cost tracker funds. Just because you wouldn't buy now certainly doesn't mean you should sell. As is so often the case in investing, once you have made a good decision, the best subsequent decision — and frequently the hardest to stick to — is to do nothing at all.

Sincerely,

Justin Kobe, CFA
Founder, Portfolio Manager & Adviser

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