Bernzott Capital Advisors

PERSPECTIVES

February 2018

When is it Time to Sell?

If there is one thing that likely worries investors almost as much as falling prices, it would be rising prices. Whether stock prices are going down and no floor seems to be in sight or prices are going up as if there were no risk in buying equities, the question is often the same: Shouldn't we start to think about selling?

Any time is a good time to review our sell philosophy, and considering the volatility we have experienced in 2018, let's review the conditions where we start to consider selling:

The Company has become overvalued. We will consider selling if the price gets ahead of the business or the price ascends to an unrealistic or unsustainable level. How do we know what that level is? It is quite simple (but not easy). Recall we have a fair value calculated for each stock that is in the portfolio. Once the stock reaches this calculated fair value, we sell. So that sounds simple, but the difficult part is calculating the fair value. Our main tool for valuation is a discounted cash flow model which projects free cash flow over the next 10 years and discounts those cash flows back to present value. This fair value is reassessed at least once a quarter after the company releases quarterly financial information. Hopefully the company is performing as we hoped and fair value is raised. If this fair value remains above where the stock is trading, the stock stays in the portfolio. In some cases the stock remains in the portfolio for well over 5 years. In fact, in a perfect world we would use the Warren Buffett philosophy of "our preferred holding period is forever."

Overweighting. If one security makes up too much of an overall portfolio, some trimming may be necessary. By having a focused portfolio of our best ideas, we know exactly what we own, and we have an investment thesis for each position. That said, we never want one position to represent too much of the value of the portfolio, even a rock-solid, steadily performing mega cap company.

Deteriorating fundamentals. If there is an unfavorable change to the company or the industry, and that change is material, we will sell. Part of our continual evaluation of the companies in the portfolio is assessing the preservation of our original thesis. We ask ourselves if the competitive environment has changed. Has the market for the company's goods or services deteriorated? Have the risks that we considered remote now become more possible? In the end, if conditions in which the company operates have changed and prospects for evolving with that change are slim, we will consider selling.

We made a mistake in our analysis of the company. This condition is most likely present after a significant decline in price, and therefore the most difficult to acknowledge. We make assumptions while building our models and calculating fair value, and sometimes those assumptions are faulty. We may have been too optimistic with the growth rate. We may have assumed the company would be able to be more efficient with operations. Maybe a condition we thought would be only an event turned out to be a trend. Whatever the case, when things don't turn out the way we expected them, we take an honest look at the company. If our thesis has been broken, we will sell.

After realizing a loss on a company where a mistake was made, we do a complete "postmortem" and dive into what mistakes were made, what we could have done differently, and, most importantly, what lessons were learned so the same mistake is not repeated.

<u>There is a more compelling opportunity</u>. Let's take a situation where we add a name to our buy list, the stock price is attractive and we make a decision to buy. However, if there is no cash in the account to buy the stock due to the money being fully invested in other securities, we have to decide where the money would be most likely to appreciate. In this case, we may need to sell a position that is close to its fair value in order to buy a company that is selling at a significant discount.

Notice that there is no mention of stop losses, resistance levels, 52 week highs, momentum or "gut feelings." These are tactics used by hyperactive traders and have no place in an investor's arsenal. Our job is to establish the value of the company and make decisions based on those evaluations, not historical values or charts. It is also important to note that the price we paid for a stock has no relevance in our sell decision. The value of the stock is calculated independent of what we paid for it. We remove emotion from the investment decision and do our best to avoid behavioral characteristics, such as loss aversion or anchoring, that cloud investment decisions.

Our investment discipline does not change when prices go up. If a stock price appreciates beyond what the company is worth, we need to consider selling. If a stock price declines to a price where we can buy at a significant discount to fair value, we need to consider buying.

We have done some selling over the past twelve months, mostly because valuations have approached fair value. Our biggest challenge in these market conditions is continuing to find new companies that we believe are selling at a discount. Even though new names added to the portfolio have been rare recently, we believe will continue to have opportunities to buy great companies at reasonable prices. Readers of these pages know we don't make predictions on any of the often-used points of reference such as oil prices, interest rates or GDP growth. However, we do estimate such things as revenue growth rates and margins in our pricing models. We continue to invest significant time and energy in pricing companies that are either currently in the portfolio or we are considering purchasing. We believe there are opportunities for stock pickers who make this investment. And we trust our discipline and consistency will provide successful returns over the long run.

2017 Recap and 2018 Outlook

After double-digit returns in 2016, the idea of another year with above-average returns seemed less likely. 2017 proved why we insist that making predictions is a loser's game. We enjoyed great success in almost every sector. The performance was consistent throughout the year and stock values increased due to fundamentals, buyouts and an abundance of bullish investors. Turnover continues to be low, even with several of our portfolio companies exiting the portfolio due to takeovers. Only a few names have been added over the past twelve months. So what does all this mean for 2018?

The year has started with more volatility than we have seen in while. After a great start in January, the market has been like a yo-yo in February. But, like we have written dozens of times on these pages, we don't predict, we price. And day-to-day stock price fluctuations don't change the valuation of the companies we own. People who fret about one week of price changes are likely the same ones who sold at the bottom in 2009 when they should have been buying.

Has the rally run out of steam? That question is only answerable in the rear view mirror. But over a significant period of time we are very happy with our performance and we believe getting caught up in euphoric momentum or panic selling very often ends badly. Is that a prediction? Let's just call it an observation based on years of experience.