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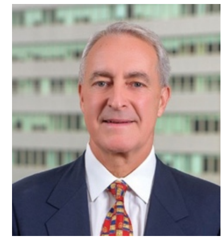

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Thoughts for Investors

Is it Time to Sell?

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Investors perpetually ask me two questions: 1. When do I think a correction or crash is coming and 2. How can I "protect" my portfolio before it happens? As the stock market has climbed from a low of the Dow Jones Industrial Average (DOW) at 6,000 in 2009 to an all-time high of the DOW at 17,000+ these questions are asked with more frequency and urgency. The drumbeat of impending disaster seems to be getting louder from the prognosticators. In this newsletter I will answer both questions and hopefully ease some concerns.

When do I think a correction is coming? Answering that is rather easy and many clients already know what I am going to say because I answer it at least five times a day. I believe it doesn't require any charts, graphs, calculations or degrees in finance, but rather a simple understanding of human emotion. The answer was best articulated by the great value investor John Templeton who said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell." In this succinct quote, Templeton explains that corrections or crashes usually occur only after bull markets reach euphoria (the rise of an index, in and of itself, does not signify euphoria). So if you are currently euphoric (maximum optimism) about the domestic or global economy or political scene, then sell right now! However, if your emotion is less than euphoric, then it is not time to sell. Investors should realize corrections and crashes will happen … eventually. Furthermore, they appreciate that anyone who claims they can accurately predict the date is guessing. What is more relevant to investors is how to protect their portfolios when the declines happen. Answering that question is also, I believe, equally easy though the execution is tough.

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

– Phillip Fisher

As for answering the second question, I believe the way to protect yourself from the next correction is to almost never sell (for purposes of this newsletter, liquidity needs aside). Please let me explain. Arithmetically, and assuming a common stock investor does not use leverage, they cannot lose more than 100% of their investment. I know that losing 100% is very painful, but that is the limit. You can't lose any more. In fact, if you are in the 40% tax bracket you may be able to, under proper circumstances, and with the counsel of your accountant, write off the loss.1 Assuming this to be the case, you really cannot lose more than 60%. Yes, that is still painful. On the other hand, what is the maximum an investment can gain? Theoretically it can be infinite (or at least very big)! Just ask Bill Gates founder of Microsoft, Sam Walton founder of Walmart, Steve Jobs founder of Apple, or Walt Disney founder of Disney. These are all very different businesses. Yet the common denominator is that all survived and their founders (and possibly a few employees and other investors) almost never sold their shares despite the ups and downs of the company, the economy, the stock market, politics and/or other business challenges. John D. Rockefeller rarely ever sold any shares of Standard Oil. According to the book Titan by Ron Chernow, at the time of the breakup of Standard Oil, Rockefeller already owned 25% of the company yet continued to buy back shares from business partners worried about the future of Standard Oil. It was a colossal mistake on the part of those who decided to sell.

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves"

– Peter Lynch

Many investors will quickly point to total losses in companies like Enron or Bethlehem Steel as to why the logic of almost never selling is flawed. In the case of Enron, it is very difficult to anticipate fraud. In the case of Bethlehem Steel, deteriorating fundamentals should have caused one to sell. Recall Fisher said almost never sell. That doesn't mean you can stop paying attention to your portfolio. I routinely review the fundamentals of the companies owned in my clients' accounts even if any are rarely sold. So why do investors waste so much time and money worrying about the next correction when the stock market rises more often than it falls (if that were not true, wouldn't the Dow and S&P have eventually gone to zero by now)? Studies have shown that humans feel losses much more strongly than gains. Clifford Nass of Stanford University was quoted in the New York Times explaining that there are both physiological and psychological reasons for this behavior.2 "The brain handles positive and negative information in different hemispheres. Negative emotions generally involve more thinking, and the information is processed more thoroughly than positive ones," he said. For example, if a stock is decreasing in value right before retirement, then negative emotion can often "outweigh" even strong positive fundamentals and result in the stock being sold in favor of a more conservative investment. Unfortunately, the downside of trying to "bullet-proof" your portfolio just before retirement is that you may need to live off it for just as long as your working career had generated a paycheck. I believe sending both you and your portfolio into retirement at the same time is dangerous … and unnecessary, if you agree with me about how the stock market works.

"Most of the big fortunes of the country were made by men who retained ownership of successful enterprises which continue to grow and prosper over a long period of years"

– T. Rowe Price

The stock market only has value to investors if it survives and goes up, and so far it has survived and gone up for a few hundred years (though historically with volatility). This is because only companies that make profits, or eventually make profits, should be expected to survive. If they never make profits, they ultimately fail and their stocks disappear. Further, surviving, profitable companies never pay out 100% of their profits. After paying their bills (labor, raw materials, shipping costs, dividends and interest, etc.) surviving companies have some profits left over to reinvest back into growing their business (or buying back their stock). It is the compounding of the reinvested profits of a company that contribute to the rise of its stock and consequently to the rise of the stock market. In my opinion, you just have to be patient to reap the benefits. Sure, it will be a roller coaster ride, from pessimism to euphoria and back. If you understand that, you can be in a position to take advantage, like Rockefeller did, of other investors' emotional mistakes.

Why am I so confident that not selling is the best way to survive a correction or crash? The answer is because for the most part, not selling has been the common theme among the most successful investors with whom I have worked over the past 30 years. It is also an underlying theme to Jack Bogle's mantra of buying an index fund and not selling. Unfortunately for many investors, it is difficult to control the urge to sell. They either want to "protect" themselves from a potential correction or crash or to "lock in" a profit before it evaporates. In reality, I believe staying invested is actually the best protection.

"If you stay rational yourself … the stupidity of the world helps you"

– Charles T. Munger, Vice-chairman Berkshire Hathaway

In summary, corrections are inevitable and the "flight to safety" is a strong urge for all creatures. But like rainy days, corrections don't last forever and unlike animals which can only act instinctively, humans enjoy the ability to control their emotions. Worrying about when the next correction is coming and what you should do does nothing to secure your financial future. What is valuable is spending the time to build a solid portfolio that can weather the storms when they come. Even better, take advantage of the opportunities that are created by all the nervous investors when their fears outweigh their better judgment.

"Paying attention to simple little things that most men neglect makes a few men rich"

– Henry Ford

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Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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