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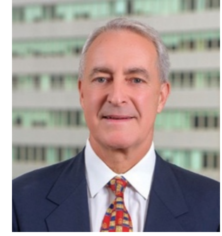

Thoughts for Investors

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Selling Too Early: What's the Rush?

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"Compound interest is the eight wonder of the world; he who understands it earns it, he who doesn't pays it."

— Albert Eienstein

"It never hurts to take a profit" is an old Wall Street saying. In the long run, I think it often does. With the recent "sell-off" in some stocks, investors are asking whether they should sell before their profits evaporate. Investors ask because many fixate on the annual percent return of their portfolio. They do this because it allows them to compare (a dangerous thing) their percent return to someone else's percent return and thereby decide if they are happy. Yet one's percent return is not nearly as important as one's total dollars of return. When you get to retirement you can't spend percentages, only dollars. While percent returns are a function of what you invest in, dollars of return are a function of what you invest in as well as how much you invest and for how long. It is easy to understand that what and how much you invest will affect your retirement income. What is often overlooked is the role of time in determining your results. Time is important because it is the critical component of compounding, and compounding is perhaps the most critical component to making money.

Compounding is having your money work for you; in essence your money making money of its own … just for you. In the interest of saving time, I will limit my discussion in this newsletter to the importance of time to investor total dollars of return.

What makes time such a difficult investment tool to use is that there are few time rules to follow, other than patience. Chemistry has strict rules. Mix a certain two chemicals together and you have a violent explosion every time whereas when investing, the same investment can either be a success or a failure due to when you get in or out and the total time invested. While Enron ended in total failure, there are some Enron investors that got out in time and at a profit. Another example is that of Mark Cuban, owner of the Dallas Mavericks. Cuban sold his dot-com company for $5.9 billion in 1999 just before the dot-com bubble burst.

"No matter how great the talent or efforts, some things take time. You can't produce a baby in one month by getting nine women pregnant."

— Warren Buffett

Time can't be rushed. This creates a special challenge for those who seek to let compounding do the work for them. If one starts saving and investing at an early age, small amounts of money, compounding, can lead to large sums near retirement age. If, however, one delays getting started, the difference at retirement age can be enormous.

For example, starting at age 35, $5,000 invested each year for five years (total investment $25,000) compounding at 7% (a generally recognized reasonable historical rate of return for the stock market) would result in an approximate total dollar return of $200,000 by age 55.

Using all the same numbers but starting 10 years later at age 45 instead, the approximate total dollar return would be $70,000.

While time can't be rushed, it can bail you out (even without the benefit of high-speed trading computers). Even if you pay a little too high a price for a good investment, given time, the investment may still "grow into" the valuation you paid, much like a too big pair of sneakers for a growing teenager.

"The key to making money in stocks is not to get scared out of them."

— Peter Lynch

Unfortunately, many investors do not take full advantage of the benefits of time and compounding. They often sell too early under the guise of "fear," "profit-taking" or "asset allocation." Portfolio returns are equal parts what you invest in, when you invest and for how long you invest. The challenge is that while what and when are usually based on financial theory, decisions about how long you invest are too often driven by behavior. During euphoric times for the stock market too much emphasis on asset allocation often drives investors to "reallocate" to popular asset classes like financials and real estate in 2007 or "tech" stocks in 1999. Likewise, during pessimistic times like 2009, emotion drives them to "allocate" too little to all stocks out of fear.

"Adopt the pace of nature. Her secret is patience."

— Ralph Waldo Emerson

Investors can be very impatient. They often feel the urge to "do something" in their portfolio and thus sabotage the chance for a good investment to compound over time. Investors will often sell simply because an investment has "gone up." The great growth stock investor Philip Fisher said, "The silliest reason to sell is that the stock price has gone up a lot. A truly great company will grow on and on. That it has advanced substantially since you bought it only means that everything is going as it should."

Selling because a stock has risen has the negative effect of fattening Uncle Sam's wallet through capital gains tax to the detriment of your own wallet. Additionally, you lose the benefit of being able to reinvest those dollars on your behalf. Selling also introduces the risk of making a bad follow-on investment. Is gold a good investment to be buying today … or selling? If a new asset class is bought, then some other asset class is usually sold. The sell decision is often rationalized with terms such as "it hit my target price" or "I have a lot of the stock" or "it has done well." In my opinion, these are not reasons to sell. Sam Walton or Bill Gates never sold because their stock hit a price target.

I believe the reasons to sell are:

— You need the money
— The fundamentals have deteriorated
— You made a mistake or
— You found a better investment

This is the sell discipline of many of the great investors such as Templeton and Fisher.

"Don't just do something, stand there."

— White Rabbit, Alice in Wonderland

In 30 years I have dealt with many investors who, despite the ups and downs of the market, remained invested, often with little reallocating, as Jack Bogle has preached. Notwithstanding the rare Enron stock that declines to zero, many of the holdings of these patient investors have wonderful compounded annual returns over decades precisely because they did not "reallocate." In the end, you can only lose 100% of what you invested, whereas gains can potentially be unlimited given enough time. Time, and maybe even a misplaced certificate found years later in a desk drawer, results in great gains.

In summary, when investing, time is not a foe rushing investors and forcing them to sell good investments, pay taxes, have less capital to put back to work and risk making a less profitable follow-on investment. Time is actually a friend. Through the magic of compounding, time does the work for you, helping your money make more money for you so that in retirement, you will end up with more “dollars” to spend. This spring, despite the recent volatility, if you own good investments resist the urge to sell too early. Take a look around you and learn from nature; it doesn’t rush, so neither should you.

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