

Making the Sale

The emotional weight that often accompanies selling a stock can contribute to selling it poorly. Here's a framework for making the sell decision as rigorous and analytical as the decision to buy. By Michael Ervolini

Take a look at any investment manager's website or pitch book and virtually all the discussion about strategy focuses on buying. Selling is typically addressed separately, as a component of the manager's "discipline." That distinction – buying is strategic and selling disciplined – says a lot about the energy and resources that are allocated between these two critical activities. The relative emphasis is clear elsewhere: While bookstore and business-school library shelves are brimming with books about how to buy stocks, little or no attention is paid to selling. Scholarly papers and trade-publication articles regularly address in minute detail how to buy, while almost never exploring the strategic aspect of selling or even referring to selling as a skill.

People are hard-wired to like buying more than selling. "It has to do with our preference for positive, future events," says Terrence Odean, a behavioral-finance expert who is a Professor of Finance at the University of California at Berkeley. "Buying is optimistic, about what the stock can do for the portfolio going forward. Selling is generally more pessimistic, about what the stock has already done to the portfolio, which may or may not have been pleasant." As a result, investors – consciously or unconsciously – derive more pleasure from buying than from selling.

Because selling can be so emotionally loaded, it can trigger a variety of ineffective behaviors, including:

Risk Aversion. This is the tendency to sell winners too quickly, well before these successful stocks have delivered their full alpha to the portfolio. Motivating these quick sells is the fear that, rather than the stock continuing to outperform, it might experience an abrupt price reversal, the result of which would be giving hard-earned gains back to the market.

Loss Aversion. This is the tendency to hold on to losers far too long. It is typically supported by a narrative about a likely turnaround, but more often than not its true purpose is to enable the manager to avoid feeling badly over realizing a loss. In a sense, when a losing position is sold, it remains a loser forever in the manager's mind, taking with it perhaps a little of the manager's confidence as well.

The Endowment Effect. This is the tendency to hold positions well beyond their productive life. Research indicates that mere possession of an item causes its perceived value to rise above the level at which the owner would have been a willing buyer before he or she owned it. Selling "endowed" possessions can therefore become difficult, as the owner chronically values them more highly than does the market. Such behavior can lead to the well-known phenomenon of round-trip-ting – a trip best avoided.

Strategic Selling

Standard descriptions of the selling discipline typically include: 1) We sell when our thesis for the stock has been realized; 2) We sell when the fundamentals significantly change; and 3) We sell opportunistically when we identify better uses of our capital.

These aren't terrible reasons for selling a stock, but they don't particularly suggest strategic thinking. This was borne out in a survey of professional investors that my firm, Cabot Research, conducted in 2008 with the CFA Institute. The results highlighted that most sell decisions are based on judgment, feel and instinct – less than 15% of the respondents said they used a rigorous and calibrated method for identifying sell candidates.

Becoming a more strategic and skilled seller starts with a conceptual model for choosing sell candidates. The basic notion

should be to keep your capital invested where it has the greatest likelihood of outperforming. Selling winners once they start to experience negative momentum, for example, is often too late. A better strategy is to sell as the winner begins to approach its likely exhaustion, say, when its price is increasing at a slower rate.

It is impossible to accurately predict when a stock will reach its peak, but the next best thing is to know under what circumstances you tend to make sell errors and use this knowledge to challenge your position management. This level of self-awareness requires rigorous analysis of one's actual behavior. One useful method involves comparing a portfolio's actual performance to that of a hypothetical portfolio that includes all the same buys, but adjusts all sells to reflect the portfolio's average holding period. When the performance of the actual portfolio exceeds that of the hypothetical portfolio, it suggests that on average the manager's sell decisions are adding value – selling is generally skillful. When the performance of the hypothetical portfolio exceeds that of the actual portfolio, it indicates that sell decisions had an overall negative impact on performance.

Common Errors

Results of this type of analysis, performed by Cabot Research on more than \$400 billion in professionally managed equity portfolios, show that a surprising number of managers generate alpha with their buys and then give it and more back through ineffective selling. To focus managers on what's working and what isn't, the analysis examines four basic scenarios: Are winners that are held for less time than the portfolio's average holding period consistently sold too quickly? Are winners held for longer than average consistently held too long? Are younger losers

consistently sold too quickly? Are older losers consistently held too long? The case studies that follow highlight some of the most prevalent selling mistakes:

Letting go is hard to do. Consistent with the endowment effect, one large-cap value manager exhibited a clear ability to make buys that outperform on average, but he also held winners well beyond their ability to effectively contribute to performance. His buys typically began to run out of steam after being held for between 2 1/2 to 3 1/2 years, but a substantial portion of his winners were held for much longer. Our analysis indicated that selling winners in a more timely fashion could predictably net this manager another 120 basis points in performance annually. In fact, because his tendency to hold winners has been getting stronger in recent years, the potential improvement in performance is even higher. The manager now keeps careful track of which of his positions are “older winners,” reconfirming each investment thesis regularly.

A bird in the hand. A small-cap growth portfolio manager with strong five-year overall performance was shown to be overly risk averse, selling many of his winners well before they hit their peak performance. The data identified a consistent tendency to sell younger winners after just seven to nine months, whereas delaying the selling of these positions to somewhere between 1 1/2 and 2 years would have added in excess of 200 basis points of incremental return annually. This manager is now “thinking twice” before selling younger winners and is monitoring more closely how these positions are performing each day they remain in the portfolio. As an added benefit, slower selling of positions has helped this manager deal with the liquidity constraints of the small-cap market.

The sun will come out tomorrow. Analysis of one mid-cap manager’s portfolio showed that positions with an unrealized loss of 30% or more were being held well beyond the average holding period, and that they consistently did not

bounce back. This behavior was most notable with positions exhibiting relatively low price volatility. By pushing out deep losers more quickly, Cabot estimated that the manager could add 180 basis points of annual performance. The benefit comes both from limiting additional losses and from redeploying “dead” capital into positions with a better chance of outperforming. Previously unaware of the extent of his loss aversion, this manager now receives automatic alerts that encourage the selling of big losers sooner.

Despite the many emotional challenges presented by selling, it is an investment skill like any other that can be improved. Improvement, however, requires a realistic understanding of one’s current ability and process, plus rigorous data analysis to help indicate where refinement can help. When it comes to selling, small incremental improvements can go a very long way. **VII**

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