

Dealing with Investment Turkeys: When to Hold, When to Fold

I once knew a charming woman who confided to me that her basis for keeping an investment was whether it was above her cost. Anything below cost should be sold immediately. Unfortunately for her the bulk of her portfolio consisted of an inherited bank stock which had a cost basis of a dollar or less. Selling would have triggered capital gains taxes. And besides, it paid such a good dividend....

Anyone who survived the past two years can surmise how this scenario played out. The dividends declined in tandem with the stock's price and while the stock is still above her cost, it is not nearly so compared to a few years back. This and other such tales from other market cycles beg the question, when should a stock be sold?

There are two schools on this topic. One is the believers of technical analysis who treat stocks as casino chips. What a company does matters less than how the stock moves. Using elaborate charts technicians try to surmise when a stock has reached its peak to decline thereafter. This approach tends to be popular with brokerage firms as it encourages trading and turnover, which is how a brokerage firm makes its money.

A second school advocates treating stocks as pro-rata shares in a business. By analyzing the business one can decide if the stock has future potential commensurate with its current price. This approach relies on fundamental analysis of the company which results in its practitioners being labeled fundamentalists.

Both approaches rely on incomplete information. Without incomplete information there would be no appreciation potential. With complete information such potential would already be known and reflected in the price of the stock. This lack of preciseness relative to the future tends to drive more cerebral investor types nuts as their efforts to treat investing like some sort of lab experiment eventually blow up.

Because of incomplete information prudent investors tend to diversify their holdings. Typically a portfolio of 12-20 stocks or an equal number of bonds tends to reduce if not eliminate the impact of any one investment going south and taking the entire portfolio with it. It does not eliminate the potential of the entire market going south, as was the case a year ago.

In a like vein, rising markets can carry most all stocks along with it, as we have seen since early last March. It is important to realize that day-to-day stock price movement simply reflects the number of buyers relative to sellers. It does not as such validate one value over another.

Warren Buffett once said that in the short run the stock market is a voting machine. By this he meant that prices rose or fell due to the ebb and flow of demand relative to supply. Over time, he said that the market is a weighing machine, meaning that the company's fundamentals become more important in determining valuations.

While money can be made trading stocks short-term, it is a very risky game. Typically investors are competing against firms with lower transaction costs, more powerful computers and better access to information. The eventual reward is to accumulate short-term gains that are fully taxed as income or losses that can only shelter \$3,000 of other income per year.

A more fundamental approach tends to be tax-favored with low long-term capital gains rates. It is also less risky in that being right over a longer time horizon is easier than being right over a short horizon. Option traders, who generally have to be right within at most nine months of their trade, are a case in point. Being right in a year counts for nothing when your investment expires before then.

There are several tenets in investing that have been proven in case studies. Stocks with low price/earnings ratios outperform stocks with high P/E ratios. Low price-to-book-value stocks tend to outperform high price-to-book-value. Stocks of mid-sized companies tend to outperform both large firms and smaller ones.

The problem with such generalizations (besides the exceptions) is that there is sometimes a time lag of several months if not years for these trends to bear out. Most investors lack the patience to do individual investment research, much less stick with a stock or strategy that is doing poorly. Thus investors come up with mechanical reasons to sell, such as when a price falls seven percent or whatnot. Such rules are not so much a strategy as a poor substitute for one. In last year's decline many investors abandoned stock A due to its decline, only to buy stock B and have it decline as much or more than if he or she had stayed with stock A. After a few rounds of this such investors fled to the sidelines and missed much of the leg up.

Warren Buffett was once quoted as saying the ideal holding period for a stock is "forever". This is not to say Buffett has never sold a stock. Indeed he has had his share of turkeys. What he is saying is that a long-term approach should be the intent of the investor. Nothing short of subsequent adverse information or a more promising investment opportunity should change a stock holding once it is researched and purchased. As the richest person in the world who made his wealth solely by investing, his words should bear examination and reflection.

The Economy

The economy is sending off the mixed signals typical of the early stages of an economic recovery.

While industrial production and exports continue to boom, the housing market has shown some signs of slowdown. Part of the reduction was the tardiness of Congress in extending the \$8,000 tax credit for home purchases. Now that it is back on the books until April housing should come back a bit. However, as the driver of the economy in the last cycle, housing should not be expected to occupy such a position in the next upturn.

Looking ahead, the year-to-year comparisons will continue to be easy through the first half of 2010. Hopefully by then there will be enough pent-up economic demand to sustain the recovery going forward.

Interest Rates

There is clearly no impetus to tighten interest rates by the Federal Reserve. Through various pronouncements Government officials have let it be known that no increases will be entertained until the second half of 2010 and only if economic demand justifies it.

However the second half of next year will be the mid-year elections. It is not unprecedented for rates to be influenced by politics. Typically this would mean keeping rates low. However since they are already low, this time around may mean an increase in rates to appeal to retirees who have suffered as returns on cash have declined.

Inflation

Much of the aggressiveness regarding interest rates is the result of the low inflation rate. In the short run this should continue as there is an abundance of most materials and labor.

The first sign of inflation will come from less discounting as retailers keep less inventory and hold fewer sales as a result. The auto dealers have already experienced the joys of charging more for a car when there are fewer cars on the lot and fewer competing dealers. This trend is expected to expand to other retail lines as well.

The Stock Market

While the market continues to advance, the rate of gain has decelerated of late. This may be a precursor of at least a short-term correction as momentum and technical-driven investors cash in gains.

However, with interest rates so low and investment options few, stocks will continue to hold a position of prominence. In order for stocks to move higher with confidence there will be a need for increased revenues. This should be on tap for at least some industries in 2010.

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November 20, 2009

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