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INVESTMENT PERSPECTIVES

Selling is Much Harder than Buying

We have talked *ad nauseum* about our approach to buying stocks. While it is of paramount importance to “buy right”, it is of equal importance to “sell right”. There are many pitfalls to overcome in determining the appropriate time to sell. We will discuss some of these below as well as our approach to selling.

First of all is the psychological hurdle that some people have to ever selling because their *psyche* is in the stock. They are in love with the stock. If a stock goes up after they buy it, and continues to go up for some time, they start to believe that it will always go up. So it is impossible to develop a strategy that envisions selling. There are no ground-rules to follow when you are in love!

Another reason some investors adopt a “never-sell” stance for securities is their favorable experience in their real estate investments over the past 30+ years. We should note that there is a major difference between good real estate and common stocks. A company can issue as much new stock as it wishes so there really never is a limited amount of stock in that company. Also, there are usually a number of companies that offer the same product. If one company can make the product better or more cheaply, and their earnings soar, their competition will eventually catch on and do the same. The end result is the common stock price goes up or down based on investors’ perceptions of future earnings. Well-located real estate cannot be duplicated and rents can be increased as the demand in that location grows over time. Perhaps Will Roger’s said it best: “Buy land, they ain’t making any more of the stuff”. For these reasons, common stocks tend to rise and fall further and more often than real estate. As a result, a sound selling discipline is mandatory when investing in common stocks.

Greed plays a strong part in investing for many people. They hear good things about the stock – earnings are growing, sales are strong, all analyst reports are rosy, and there is little or no negative press. As a stock continues to rise, often with no apparent underpinnings, people become involved in a “feeding frenzy”. They don’t believe that anything can go wrong with the stock, even though all normal standards of valuation are flashing red. In the tech boom, virtually every dot.com stock was extremely over-priced, but people kept on buying until the very end of the bubble in March 2000.

A well recognized example of investors' greed clouding selling judgment is Cisco Systems stock in the late 1990s into early 2000. During this period Cisco was a media darling. There was a constant stream of articles covering their impressive growth and the riches being accumulated by its stockholders. Meanwhile, Cisco's stock price climbed from \$24 a share at the end of 1998 to \$53 a share at the end of 1999 and reached a high of \$82 dollars in early 2000. Although Cisco did have impressive growth, its P/E ratio of 154 was more than 10 times higher than the historical stock market average P/E ratio of 15! The high P/E ratio was a very significant warning signal that the stock price was off the charts. Those who fell victim to their own greed have had to painfully watch the price of Cisco fall by the end of 2002 to \$8 a share and a more earthly P/E ratio of 20. Its current price is about \$18 per share with a much more realistic P/E ratio of 17.5. By the way, we suspect that Google may be a "modern-day" Cisco, with a P/E ratio now of about 54.5.

Fear is another factor. Many people will not sell because they are afraid that the stock will go up right after they sell. This was clearly evident for most investors who owned Cisco at the top and never sold it on the way down. Whether or not the stock price goes up or down right after they sell is irrelevant – it did not go up or down because they sold.

For professional money managers, different sets of rules may apply. If you were a mutual fund manager, for example, you must strive for results that at a minimum mirror the results of your peers, and you must own the right stocks (those stocks that have done well) during each quarter. So, mutual fund managers are competing against each other in a performance derby in order to win your money. Their results at the end of each quarter or each year will determine if you invest in that fund, and - in the longer term - will determine if they keep their jobs. That is why a significant number of actively-managed U.S. mutual funds have turnover rates of over 100% per year that generate high trading costs of approximately 1% per year (in addition to management fees that average about 1.5% per year).

Here is how Hutchinson Capital Management makes its sell decisions:

- First of all, we are not in a performance derby -- we do not need to achieve short-term results for new stocks that we buy. What we do expect is that our stocks will perform well over time. For example in the year 2000 when the S&P 500 was down by 9.2% our results were plus 7.2%. Some stocks that performed well in 2000, such as Chubb, Pepsico, Merck, and BRE, had been purchased from 2 to 5 years earlier.
- We have consistently believed over the years that it is very important to not follow the "crowd" when it comes to investing, because their collective judgment after the price of a stock has increased significantly is usually wrong! We believe it is very important to be a contrarian and to always make a sell decision based on the appropriate facts – not on the emotion of the moment!

We make “original” buy and sell decisions based on our analysis of the relevant factors that determine the long-term price of a stock. We utilize our many contacts all over the world who are both involved with analyzing common stocks and who are leaders in their respective industries. We also have our own disciplined process of analyzing and monitoring the companies in which we are interested.

In arriving at a sell decision it is important to note that each industry has different measures of valuation. It is very important to know the appropriate measures in each company and industry in order to make an intelligent sell decision. For example, in banking it is critical to monitor the net interest margin while in the office supply business net interest margin isn't even a consideration. A high P/E ratio in one industry may be a mid-level P/E ratio in another industry. In some cases a weakening of key fundamental ratios may be a warning sign that the overall health of the company is deteriorating. In such cases, we always find out what the management of the company is doing to correct the problem before making any sell decision.

- When a stock doubles from our original purchase price, we typically sell half of the original position (as long as it is a long-term capital gain). If the fundamental underpinnings of a company remain intact, even though the price has doubled or tripled, we will continue to hold a portion of the original position.

For example, we originally bought Office Depot in July 2000 for about \$6.50 per share. Over the next 15 months, the stock rose to over \$14.00 per share. We still believed Office Depot to be a worthwhile holding, but given the then sluggish economic environment, we did not want to be over-exposed to any one stock, so we sold half. By June 2005, the stock had increased to \$22 and we once again sold half of the position. We finally sold all of our Office Depot holdings in August of 2005 at \$29 per share. At that time the valuation was at the high end of its historical range with a P/E ratio of 21.5, and there was a significant change in leadership direction that carried considerable risk. Based on these and other fundamental valuations, we felt that the stock had considerably more downside risk than upside potential.

Our sell discipline has helped our clients to achieve less volatility in their portfolios over time. Our goal is to provide competitive returns in rising markets while preserving wealth in declining markets – in other words, intelligent and consistent growth of capital.