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WHEN TO HOLD 'EM, AND WHEN TO FOLD 'EM – PART I – TEXT

It has been pointed out that well over 90% of all the research recommendations generated by Wall Street are recommendations to buy. Recommendations to sell are few and far between. Yet, who can deny that a timely sale may be just as critical to a successful investment as a timely purchase? As some investors incurred gargantuan losses and others saw their profits evaporate in the bear market of 2000-2002, that reality in common stock investing was driven home loud and clear. It is our purpose here to discuss some metrics useful in deciding whether to continue to hold a stock or to sell it.

ANALOGY #1

Monitoring a common stock may be likened to watching a neighbor walk his dog. At any given time, the dog may be running to the left of his master or to the right of him; he may be running ahead of him or running in the opposite direction. Exactly where the dog will be at any instant and why he will be there are, for the most part, unpredictable. What is reasonably certain, however, is that, at the end of their walk, our neighbor and his dog shall arrive at the same destination. The best way to figure out where the dog is going to end up is to try to figure out where our neighbor is going. It is considerably less reliable to try to predict the itinerary of the two by extrapolating any of the random excursions made by the dog.

Similarly, in trying to predict the course of the price of a common stock, it is far more productive to focus on the performance of the underlying company than it is to study the short-term random patterns presented by the price of the stock. Over the longer term, if a company does well, it is nearly inevitable that its common stock will also do well; and vice-versa.

ANALOGY #2

Let us suppose that we are asked to predict what grades each student in a high school class will earn in his sophomore year. We have available lots of data on each individual student such as his involvement in extra curricular activities, but probably the best indicator we could have of what grades he might get in his sophomore year are the grades he got in his freshman year.

Similarly, by far the best guess we can make about how a company will do over the coming year is to examine how it has been doing over the past year. There are always many exceptions but it is a simple fact that companies that are doing well today are more apt to do well tomorrow than companies that are already in trouble and doing poorly today are apt to turn themselves around and do well tomorrow. In common stock investing we try to keep the odds in our favor, and this is one good way of doing it.

EARNINGS MOMENTUM AND *VALUE LINE* "TIMELINESS" RANKS

How do we measure how well a company is doing today, or at least has been doing in the recent past? Generally speaking, companies whose earnings are increasing faster (or decreasing more slowly) than the average company are said to have "positive" earnings momentum. Companies whose earnings are increasing more slowly (or decreasing faster) than the average company are said to have "negative" earnings momentum.

The most widely subscribed to investment service is the *Value Line* service and much useful information can be obtained from it. *Value Line* is best known for its weekly earnings momentum ratings which it calls its "Timeliness" ranks. A "Timeliness" rank of a #1 or a #2 indicates "positive" earnings momentum and is accorded to the top 400 companies (23.5%) of the 1,700 stocks ranked by the service. A #4 or a #5 "Timeliness" rank indicates "negative" earnings momentum and is accorded to the bottom 400 (23.5%) of the *Value Line* universe. This leaves 900 or slightly over half (53%) of the 1,700 stocks with a neutral "Timeliness" rank of #3.

Historically, a simple and effective discipline has involved purchasing stocks with *Value Line* "Timeliness" ranks of #1 or #2 and selling them when their rankings dropped to #4 or #5. It should be cautioned, however, that to have avoided the high-tech debacle of the 2000-2002 bear market, it was necessary also to have confined one's purchases to "high-quality" stocks which may be defined as those carrying *Standard & Poor's* ratings of A-, A, or A+.

GOOD #3S AND BAD #3S

Because stocks that carry #3 *Value Line* "Timeliness" ranks constitute such a large part (over half) of the *Value Line* universe, it is useful to try to differentiate those #3s that may have stumbled only temporarily from those that are in more serious trouble. We call the former "Good #3s" and the latter "Bad #3s." A Good #3 is more apt to become a #2 the next time its rank changes than it is to become a #4; and a Bad #3 is more apt to become a #4 the next time its rank changes than it is to become a #2.

One of the greatest challenges, then, in the management of a common stock portfolio becomes discriminating among stocks with neither strong positive nor strong negative earnings momentum — distinguishing between Good #3s and Bad #3s.

PRICE MOMENTUM AND *VALUE LINE* "TECHNICAL" RANKS

While "earnings" momentum is a part of what is called the "fundamental" analysis of common stocks (querying our neighbor as to where he is going), "price" momentum is a form of "technical" analysis (trying to discern from watching the dog where it is going).

While fundamental analysis tries to predict the course of a common stock mostly by trying to predict the fortunes of the underlying company, technical analysis tries to infer predictive

information from the behavior of the price of the stock. Price momentum tells us whether a stock's price has recently been outperforming or underperforming the average common stock. If a stock's price is rising faster (or falling more slowly) than the market as a whole, it is said to have "positive" price momentum; and, if its price is rising more slowly (or falling more rapidly) than the market as a whole, it is said to have "negative" price momentum.

In spite of its shortcomings, price momentum appears to have some value in the analysis of common stocks. The rationale behind its use is that it may tell us something about what is going on inside a company that is not yet in the public domain. Historically, for example, insider selling in advance of publication by a company of bad news has been indicated by negative price momentum. (This is one of the ways the Securities & Exchange Commission is alerted to the existence of insider trading.) Such activity by insiders, of course, may be illegal and so presumably is not as prevalent today as in the past, but there are many other things that go on inside a company that indicate the course of future earnings that may influence the price of a common stock but which are not yet revealed to the public.

For example, a company's salesmen may observe that the level of the new orders they are getting has been plummeting. They may sell their company stock and tell their friends to sell theirs. They are not insiders and so this is not illegal; yet it is information that is not yet available to investors or to analysts, and the selling may have an adverse effect on the price of the stock. This might be picked up as negative price momentum.

Again we can utilize the *Value Line* service. *Value Line* publishes weekly what it calls its "Technical" ranks for each of its 1,700 stocks. This is a measure of each stock's price momentum. And, again, *Value Line* uses a scale of #1 through #5 for these rankings, with the same proportion of the 1,700 stocks in each category as with its "Timeliness" ranks.

Our studies indicate that, if a stock has a "Timeliness" rank of #3 this week, and it also has a "Technical" rank of #4 or #5 this week, it is about four times more likely next week to become a "Timeliness" #4 than a "Timeliness" #2.

It is important to note that, insofar as *Value Line* "Technical" ranks reflect information outside the public domain, it is not possible, reliably, to ascribe reasons for the ranking, other than the price trends themselves. It may, nevertheless, be prudent to act upon changes in the "Technical" rank in an effort to avoid some of the price decline that typically precedes a downgrade in a "Timeliness" rank.

Value Line "Technical" rankings, then, appear to be a useful tool in trying to discriminate between Good #3s and Bad #3s.[*]

[*] Though I have not encountered the recommendation in the service's literature, in a July 14, 2000 telephone conversation, *Value Line's* Research Chairman, Samuel Eisenstadt, told me that he thought using the "Technical" ratings to discriminate among "Timeliness" #3s was a "good idea."

INDUSTRY CONTAGION AND *VALUE LINE* INDUSTRY RANKS

We expect companies that are well-managed to do better than those that are not well-managed. If, for example, a company is able to increase its market share in its industry, it may be presumed to be better managed than a company in the same industry that is losing market share. Sometimes, however, even the best-managed companies are overwhelmed by deterioration in their industry. The only questions are when and how severely they are impacted. If we have a measure of the overall state of, and outlook for, a company's industry, then we may be better able to get a feel for the timing and magnitude of this impact.

Again, *Value Line* may be able to help us. The service ranks industries and other market sectors collectively and weekly on the basis the "Timeliness" ranks, or the earnings momentum, of the companies in each industry or sector. It currently has its 1,700 stocks categorized into 98 industries or sectors and ranks them from #1 through #98, with the former indicating the most promising, and the latter, the least promising.

Our studies indicate that, if this week a stock's *Value Line* "Timeliness" and "Technical" ranks are both #3 and it is in an industry with a *Value Line* "Timeliness" ranking that is greater than 75, its "Timeliness" rank next week is twice as apt to go to a #4 as to a #2.

Once again, *Value Line* appears to provide us with a tool that is useful for discriminating between Good #3s and Bad #3s.

"OPERATING" EARNINGS VERSUS "NET" OR GAAP EARNINGS

"Operating" earnings are earnings where so-called non-recurring gains and losses, as from the sale of a discontinued operation, are excluded. "Operating" earnings are said to be more indicative of the current performance of a company's core or current operations and so more useful for analytical and predictive purposes. *Value Line* publishes "operating" earnings for the companies it monitors.

"Net" or GAAP (Generally Accepted Accounting Principles) earnings, on the other hand, are earnings as published by a company before any adjustment for any non-recurring gains and losses. Most high-quality growth companies do not have many significant non-recurring gains and losses, in which case "operating" earnings and "net" earnings are the same or nearly so. Many companies of lower quality in more cyclical industries, however, have chronic write-downs and so there is a great disparity between "operating" earnings and "net" earnings. Furthermore, studies have indicated that the price of a common stock more closely correlates with "net" earnings than with "operating" earnings; hence, for some companies it may be more useful to look at the former than the latter. *Standard & Poor's* publishes "net" earnings.

TRENDS IN THE RATES OF GROWTH OF EARNINGS AND SALES

It is frequently useful to study trends in the rates of growth of various company parameters. If a company's earnings per share are growing but each quarter's growth is less than the previous quarter's growth, this may be an indication that the company is headed for no growth or negative growth. Even if earnings per share continue to grow dynamically, but sales per share growth is slowing, there is apt to be trouble on the horizon. Earnings growth may be being achieved by cutting costs, raising prices, leveraging the balance sheet, or even by fuzzy accounting, none of which are usually long sustainable.

VALUATION

Valuation refers to the relationship between the price per share of a stock and some other per share parameter, the most common of which is "earnings," whereby we see and hear reference to the ubiquitous price-to-earnings ratio (P/E). When the P/E of the average stock is 20-to-1, a stock with a P/E of 10-to-1 may be considered to have a low valuation while one with a P/E of 40-to-1 may be considered to have a high valuation. Other useful measures of valuation include the ratios of price-to-sales, price-to-cash flow, price-to-dividend (the reciprocal of the dividend yield), and price-to-book value.

A stock will have a below-average valuation because the investing public considers the underlying company to be of below-average quality and/or to have below-average prospects, or it will have an above-average valuation because the investing public considers the company to be of above-average quality and/or to have above-average prospects. High-quality growth companies typically have above-average P/Es.

Valuation appears to be more useful in assessing the risk inherent in the ownership of a particular common stock than in assessing its future prospects. For example, if, at a time when the average stock sells at 20 times earnings, a particular stock sells at 40 times earnings because its company is held in especially high esteem, a reassessment by the public that the company is only an average company, all other things being equal, will result in a 50% decline in the price of the stock.

In addition to comparing the current valuation of a company's stock with the average of all stocks, it may be useful to compare its current valuation with its historical valuation. If a stock that has typically sold at 25 times earnings is now selling at 35 times earnings, its price is probably vulnerable to a greater decline than it has typically been in the past.

An above-average valuation is clearly not, in itself, a signal to sell. If we sold all our stocks with above-average valuations, we would be left with a portfolio of stocks of only low quality and/or poor prospects. The higher level of risk associated with a stock that has risen to an inordinately high valuation, however, may make the stock no longer suitable for a particular investor, in which

case it should be sold; or, such a rise in price may make it prudent merely to pare down the size of the position in the interest of maintaining broad diversification.

BUBBLES — RECOGNIZING THEM

A common stock bubble is a high valuation in the extreme. The 1998-2000 high-tech bubble witnessed many P/Es well above 40x and some much above 100x. For such companies, the ensuing collapse far exceeded 50%.

A bubble presents two challenges: recognizing it and acting upon it. To recognize a bubble, we need to define it and be able to measure it. To measure it, we first need to utilize the concept of the "relative" P/E which we shall refer to as the RP/E. If the market has a P/E of 20x and our stock has a P/E of 30x, our stock has an RP/E of 1.5x (30/20). It is necessary to relate the P/E of a stock to the P/E of the market because a "rising tide raises all ships." A P/E of 20x will be high if the average P/E of the market is 15x, but 20x will be low if the market is 25x. *Value Line* publishes the current and historical RP/Es of the stocks it follows.

Unfortunately, the task of measuring a bubble is still more complicated. We must now relate the stock's current RP/E to its historical RP/E. That is because some stocks always sell at an elevated RP/E, and so the RP/E alone does not tell us enough. If we relate the stock's current RP/E with its historical RP/E by dividing the former by the latter, we come up with a parameter we call the "Relative Relative" P/E or R^2P/E. When the R^2P/E of a stock exceeds 1.5x, we say it is in bubble phase. At their peaks the big name high-tech companies had R^2P/Es that ranged from 2x to 8x and averaged about 5x. At their subsequent bottoms in 2002, they were down, on average, over 90% from their highs.

BUBBLES — DEALING WITH THEM

If we can recognize bubbles, we can avoid them. We can either not buy a stock that has become a bubble or can sell a stock we own when it becomes a bubble. If we do not own a stock in bubble phase, we are not hurt when it bursts.

But, if we never own a stock in bubble phase, we also never have the opportunity to enjoy the extraordinary gains which characterize the evolution of a bubble. From the time the big name high-techs came into bubble phase in the 1998-2000 bubble market until their peaks, they appreciated, on average, about five-fold.

If we quintuple our money and then lose 90% of it, however, we end up with a net loss of 50%. Clearly, the challenge is to participate fully in the bubble's formation but less than fully in its demise.

One way to control one's risk in the ownership of a stock in bubble phase is to adhere to a policy of diversification. As the value of the position grows, portions of it can be sold. Then, when the bubble bursts, some profits have been salvaged. More specifically, we suggest selling half the position when a stock's R^2P/E reaches 2x, selling half of what remains at 3x, and continuing to sell the residual half each time the bubble reaches a new whole number of magnitude. For a stock that quintuples and then declines 90%, the arithmetic suggests that, with this strategy, we should still end up with two-and-one half times our original investment.

Interestingly, *Value Line* could have been useful in dealing with bubbles in a more aggressive manner. To have been successful, however, we needed to respond to changes in the *Value Line* "Timeliness" rankings much more rigorously than usual. If a stock was ranked #1, we needed to sell if it dropped to a #2; or, if it was a #2, we needed to sell if it dropped to a #3. In bubble phase, all #3s were "bad." Our studies indicate that such a strategy would have limited the decline in most large high-tech stocks to about 30%, instead of 90%. If we own a stock that quintuples and sell it after a decline of only 30%, we enjoy a net gain of 250% (three and one half times our original investment).

INSTITUTIONAL HOLDINGS

Financial institutions, such as mutual funds, pension funds, insurance companies, bank trust departments, and university endowments, are the largest holders of common stocks and, as such, whether they are collectively buying or selling a stock can have a significant impact on the way the stock performs in the marketplace.

Institutional sales activity in a stock, however, is more of a "coincident" than a "leading" indicator, in that institutions tend to demonstrate a herd instinct in their buying and selling. Nevertheless, significant institutional selling may serve to confirm the suspicion that a company's problems may be of long duration, rather than temporary, and so provide further evidence that a *Value Line* #3 may, indeed, be a "Bad #3." Data on the institutional holdings of common stocks is available in *Standard & Poor's Stock Guides*.

INSIDER TRANSACTIONS

It has been argued that insider activity is the most reliable of all indicators as to the fortunes of a company. Presumably the top management, board of directors, and largest shareholders of a company know more about what is on their company's horizon and know it sooner than does anybody else.

Though they are barred by statute from blatantly taking advantage of such knowledge by buying or selling shares just before major announcements of good news or bad news, they may legally take advantage of such knowledge in other more subtle ways. If they anticipate bad news down

the road, they may simply not purchase shares they might otherwise have purchased in the absence of the prospect of bad news; or the bad news they foresee may be so far into the future that a sale today will cause them no problems with the SEC. Similarly, if they anticipate especially good news, they may borrow the money to purchase their new yacht, rather than selling their company stock to pay for it.

In any event, by studying insider open market transactions, it is frequently possible to infer strong faith, or a lack thereof, on the part of insiders in the future prospects of their company. Insider trading activity is readily available on the Internet.

OTHER CONSIDERATIONS

Given the many unpleasant surprises that go with the territory of common stock investing, there are often considerations, other than a company's future prospects, that determine whether a stock should be held or sold. Among the most important of these is diversification. If a stock has gone up so much that it now constitutes an inordinately large part of the whole portfolio, some of the stock should be sold, no matter how promising the company otherwise looks.

In a taxable account, tax considerations may be an important factor. If a stock is held at a loss and its prospects seem less than promising, Uncle Sam may, in effect, subsidize our getting into another stock with greater promise.

CONCLUSION

It appears axiomatic that, if a common stock portfolio is expected grow, it must be populated with the common stocks of companies that are growing. It is said that, on average, a company remains a growth company for about four years. The spectrum is very wide, however. For some companies the growth phase may last just four months and, for others, the good life may go on for four decades. A policy of occasionally weeding out those companies in a portfolio that no longer meet the criteria by which they were acquired, and replacing them with companies that do, appears both to enhance the portfolio's potential for growth and to provide added protection against adversity. The techniques described above have proved to be most useful in this endeavor.

If you would like further information on the rationale for, or implementation of, any of these strategies, please give the Dows a call.

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