

Know When To Sell

Seriously Hip Investment Club

by Maury Elvekrog, CFA



"Portfolio management has become a hot topic among our members We purchased our first shares in May 2000. . . . Three of our 12 stocks have more than doubled in value, Express Scripts . . . , Concord EFS . . . and AmeriCredit. We've talked about selling ESRX and CEFT . . . , " writes Tim Smith, financial partner of the Seriously Hip Investment Club of Houston.

As always, selling continues to be the most difficult part of effectively managing a portfolio. In the present market atmosphere, members of many clubs are scratching their heads over the question of whether to sell before more losses occur.

It's therefore refreshing to run into a well-organized young club like Seriously Hip whose members are concerned about whether they should sell because the valuations of some of the stocks have gone up so much.

My answer to the question of selling simply because a stock has risen in price is, "no." Since this is such a difficult and befuddling question, let's spend some time thinking about it.

Buying a stock is always a matter of balancing the two essential independent questions: (1) How good a business is this? and (2) Am I able to buy the stock at an acceptable price? Does that mean selling should be determined by significant changes in either of these?

Certainly, if the business of the company shows signs of significant deterioration, this is an immediate trumpet call to sell. But what if the business remains good, yet the value of the stock rises to the point that you would not buy it at this price? Does this mean you should immediately sell it?

Again, I say, "no." Almost all experienced investors are extremely slow to sell their winners. The reason is that it's not that easy to find a really good company in which to invest.

Selling the stock when it gets overpriced implies the price will come down to an attractive level at which you can buy again. This effort at timing works no better with individual stocks than it does with trying to time the market's ups and downs. It may well be that the

Seriously Hip Investment Club

Company	No. Shares	Cost	Aug. 24, 2001 Price	Aug. 24, 2001 Value	Gain/(Loss)	%GAIN/Loss	Quality Rating	% Growth Estimate*	% of Portfolio	P/E	Trailing EPS
AmeriCredit Corp.	29	\$680	\$47.91	\$1,389	\$709	104%	3	25%	10.4%	18	\$2.59
American Power Conversion Corp.	35	706	14.33	502	(204)	(29)	4	15	3.8	17	0.82
CTS Corporation	14	710	20.02	280	(430)	(61)	3	18	2.1	17	1.16
CVS Corporation	18	695	37.98	684	(11)	(2)	3	17	5.1	20	1.89
Concord EFS, Inc.	25	700	57.74	1,444	744	106	3	25	10.8	113	0.51
Dover Corporation	19	702	37.42	711	9	1	2	14	5.3	19	1.97
Dycor Industries, Inc.	41	685	18.05	740	55	8	3	15	5.6	12	1.45
Express Scripts, Inc.	40	1,028	55.05	2,202	1,174	114	3	25	16.5	40	1.38
Fossil, Inc.	39	705	21.94	856	151	21	3	18	6.4	14	1.53
The Men's Wearhouse, Inc.	35	878	25.43	890	12	1	3	20	6.7	14	1.86
Orthodontic Centers of America, Inc.	31	718	28.60	887	169	24	3	25	6.7	23	1.26
Protective Life Corporation	28	698	30.75	861	163	23	3	12	6.5	13	2.33
Cash		1,881		1,881					14.1		
Average								19%		27	
TOTAL		\$10,786		\$13,327	\$2,541	24%			100.0%		

* As estimated by the author, with data from www1.firstcall.com.

stock of an excellent company could continue up and up, and it may take many years — if ever — to come down to a low price. Missing an outstanding investment for all those years is an extreme penalty.

Let's assume you've identified an outstanding business and have been able to buy the stock at a level the SSG says is attractive. I would recommend adopting a mindset that even if the stock rises to an excessive level, you'll be willing to live with it coming down to a normal price and not be concerned as long as you're confident the excellence of the business will continue.

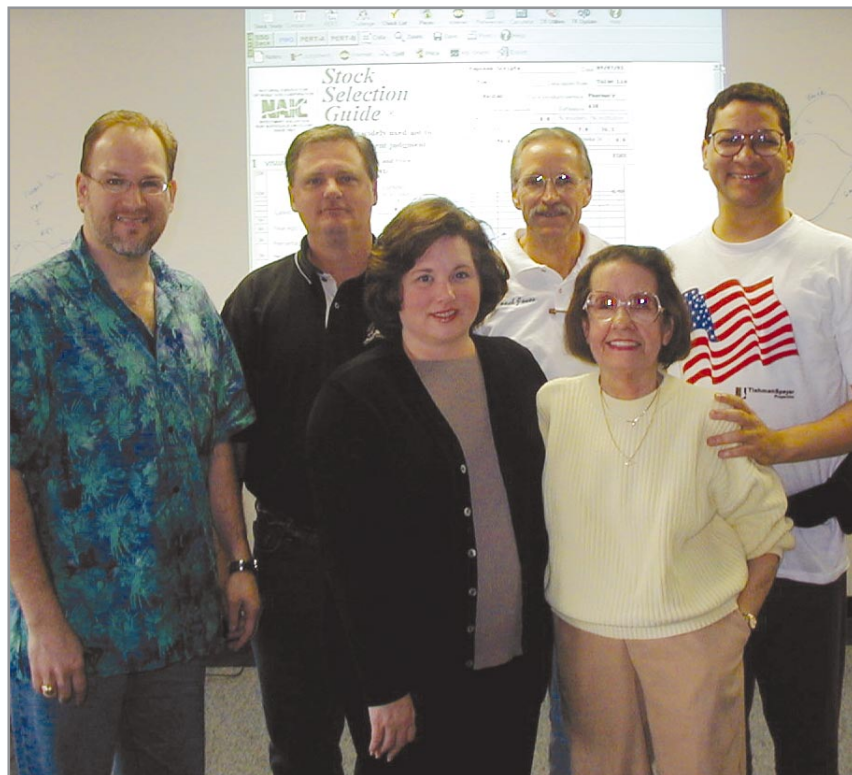
Thus, price is an absolutely essential element in the purchase decision. But once the buy is made, I would say the only reasons for selling are either deterioration in the company's business or the availability of a much better alternative. Price could influence the decision if, say, your stock has skyrocketed and an equally good company is available at a lower price. But it's often difficult to identify equally good companies.

Watch Large Holdings

For the sake of completeness, I should add that good portfolio management may involve selling a portion of a holding when the price of a stock has gone up so much that a single holding starts to become too big a percentage of the overall portfolio. In Seriously Hip's situation, **Express Scripts, Inc.** (NNM: **ESRX**), is nearing that level.

Somewhere around 20 to 25 percent of a portfolio is certainly the maximum to allow, because beyond that the whole portfolio is hostage to a single stock. Express Scripts is at a level of 16.5 percent of the portfolio, high but not excessive. I would not be in any great hurry to do anything about it.

It's unlikely, however, that Express Scripts will continue to grow as strongly as it has. Pharmaceutical distributors have been darlings of



Seriously Hip Investment Club: Pictured are, front row (from left): Darlene Plumly and Bettye Wessels. Back row (from left): Tim Smith, Jack Maley, Ed Jones and Wendell DeGrange. Not present: Don Neumann.

the market for some time. Analysts —along with other investors — get carried away by immediate results and so are projecting an ongoing growth rate of 28 percent per year for Express Scripts.

Stocks just do not grow at a rate higher than 25 percent for any significant period.

As you look at the club's portfolio, you will see that I have changed the 28 percent to 25 percent projected growth as I have moderated all the projections above 25 percent back to that level. Stocks just do not grow at a rate higher than 25 percent for any significant period.

Companies like industry leader **Cardinal Health (NYSE: CAH)** and Express Scripts have shown tremendous growth in recent years because of the use of computer reordering systems and just-in-time efficiencies in reducing inventory levels. The underlying growth of pharmaceuticals is nowhere near the level of growth of these companies, however; the growth is a one-time phenomenon relating to these new approaches, not something that can continue forever.

The second stock that Tim expresses concern about, **Concord EFS, Inc.** (NNM: **CEFT**), has held up even though a number of credit card companies have had negative experiences. The softening economy has caused credit problems, particularly for those companies that work with below-prime credit risks.

Concord makes its money from processing transactions rather than from extending credit, however. Concord has a special niche work-

ing with small businesses. This niche has allowed it to grow very impressively in recent years, but it still has to be somewhat influenced by the overall economy.

Analysts covered by First Call expect 30 percent annual growth. Again, I have reduced this to 25 percent in our table. Concord is a well-managed company with an interesting business specialty. Change could occur rather quickly, but I would not sell just because the price has gone up.

AmeriCredit Corp.

The third stock that Tim mentions as having more than doubled in price is **AmeriCredit Corp.** (NYSE: ACF). This is also a company in the finance field. Recent market realities have hit it hard, however, and the price is now about break-even.

The company finances automobile loans to people with questionable credit, and the market has exhibited concern over problems that might develop in a poor economy. These concerns came to a head Oct. 11 when the company reported a sizable increase in past-due payments and credit losses. This is a very cyclical and uncertain situation, not a long-term growth holding. Club members may want to consider selling regardless of whether it's at a gain or a loss.

Tim reports the club plans to maintain a portfolio with no more than 15 stocks, diversified by size and by industry. The stock screening guidelines the club uses include:

- PEG ratio of up to 1.0.
- P/E ratio of up to 20.
- PAR of 15 percent or more.

For those not familiar with the term, the PEG ratio refers to the price-earnings ratio relative to annualized growth. Thus, a PEG ratio of 1.0 would mean a stock with projected growth of 10 percent should be bought at no more than a price-earnings ratio of 10, with growth of 15 percent, a P/E of no more than

15, and with growth of 20 percent, a P/E of no more than 20.

A PEG of 1.0 is very desirable, and there was a point in the market's history when it was regularly used as a benchmark. It has been a long time, however, since it has been possible to buy many stocks of really good companies at this level.

Interestingly, stocks that look extremely cheap statistically, whether on the basis of a PEG ratio or just the P/E ratio, are often stocks that are deeply in trouble.

This is undoubtedly because of the bull market philosophy of recent years, but also because there have been substantial changes in the economy that might be seen to justify somewhat higher prices for the same level of growth. I believe you could stretch the usable PEG ratio higher, perhaps to 1.5, and still get excellent results from a portfolio.

Interestingly, stocks that look extremely cheap statistically, whether on the basis of a PEG ratio or just the P/E ratio, are often stocks that are deeply in trouble. The market expects them to show very poor results shortly, even though the present numbers may be good.

Low P/Es Not Enough

An interesting exercise is to look at the statistical screens sent out with the Value Line Reports. One of the most important and obvious factors in deciding whether a stock is a good buy is the P/E ratio. Yet if you look at the screen in the front of Value Line for low P/E stocks, the

first group of stocks regularly shows a significant number of companies in the process of collapsing.

Deciding how much you're willing to trust an expected growth projection is an essential preliminary to relying on statistics. Tim reports one of the club's next goals is to understand industries more deeply to determine whether they are near a downturn.

The objective of a PAR (projected average return) greater than 15 percent reflects NAIC's suggested objective of a 15 percent growth portfolio. The PAR will be familiar to careful SSG users as the number appearing at the bottom right hand of the back of the SSG form. It's based on using a "nominal" P/E as opposed to the expected high P/E (as used in Section 4A).

I would suggest instead using the total return calculation, which appears immediately adjacent and which is really what interests the investor. A 15 percent per year total return is an important element of a wise purchase decision. Good stocks that you own may rise in price substantially, however. From this higher price, the projected total return is less than the original return projected from a lower price. Still, I believe that once a stock is owned, and as long as the business continues to progress solidly, the only reason to sell is that a better investment alternative is available.

Keep in mind that the biggest part of the total return calculation depends on the growth rate you use. Sometimes it's interesting to do the annual return calculation two or three times, feeding different projected growth rates into the computer. Then make an estimate of what you consider most probable. Again, always keep in mind that the higher the growth rate projection, the less likelihood it's certain.

The club's third guideline of a P/E less than 20 is highly desirable, too.

There has to be some upper limit to the P/E you'll pay, be it 20 or 25, but somewhere in that neighborhood.

The important point is to avoid P/Es of 30, 40 or 50. These P/Es can be justified only by assuming unrealistic growth rates. Again, companies do not grow more than 25 percent per year for any considerable period. An interesting sidelight is that this P/E qualification excludes all companies (such as dot-coms) without reported earnings.

Tim's letter asks, "What should we do about stocks like APCC (American Power Conversion Corp., NNM: APCC) and CTS (CTS Corp., NYSE: CTS), that are so far down?" In other words, what should you do about stocks that have doubled in price, and what should you do about stocks that have gone way down in price?

My next point is the most important one that I want to make in this article and the one thing that I hope the reader will carry away. The answer to the question is — I don't know, I don't care, it doesn't matter, it's irrelevant.

Whether you have made money or lost money on a stock is not the issue in deciding what to do about it. At any particular moment you may have a certain amount of money to invest in stocks. Some may be in cash and some already in stocks. The focus should be on doing one's best to select a diversified portfolio of excellent businesses. If this involves selling some stocks because there are better alternatives, so be it.

The Seriously Hip Investment Club is made up of experienced investors who use the club as a laboratory, but who do most of their investing on their own. Tim reports the club "is doing better than any one of us."

It's hard for most individuals to avoid occasionally ignoring a systematic, analytical approach and

going out on their own to do a little emotional investing. I guess that's why investment clubs have such an excellent relative record.

Maury Elvekrog is president of the investment management company Seger-Elvekrog Inc. (www.seger-elvekrog.com) of Bloomfield Hills, Mich., and is a member of Better Investing's Securities Review Committee.

Portfolios are reviewed only in "Repair Shop." Portfolios are selected for review on the basis of human interest considerations, problems to be "repaired" that will teach a lesson, and other factors that can help us craft interesting columns. Send your portfolio, together with a current valuation statement and description of problems, to "Repair Shop," c/o NAIC, 711 W. Thirteen Mile Rd., Madison Heights, MI 48071. ■

Money *doesn't* grow on trees.

But it *does*
grow here.



Grow your savings with high-yield NAIC-Sponsored Deposit Accounts from MBNA America® Bank. The NAIC-Sponsored Certificate of Deposit and Money Market Deposit Accounts deliver outstanding yields and the full protection of FDIC insurance up to \$100,000 per depositor. For current rates, or to open an account, call today and an MBNA® Investor Services representative will assist you. Or visit www.better-investing.org.

Call MBNA at 1-800-900-6653.

Please mention priority code JA00A.

Monday through Friday, 8 a.m. to 8 p.m., and Saturday, 8 to 5 (Eastern time). MBNA and MBNA America are federally registered service marks of MBNA America Bank, N.A. ©2001 MBNA America Bank, N.A.

