An oft-overlooked area of investing is the question of when to sell. After all, buying is only half the work. It is crucial not to approach selling as an afterthought, something done at the end of the investment. You must approach selling with discipline, analysis, and a clear idea of what you're looking for from the very beginning of the investment. You must know from the moment you buy the investment what will cause you to sell it and why. You must know what constitutes a good reason to sell and what constitutes a bad reason. And above all, you must avoid the many emotional minefields that lie in wait in the human psyche.

Emotional decision-making is the bane of all investing, certainly of fundamental analysis. And although you always have to guard against emotional decision-making, when it comes to deciding whether to sell, you have to be extra-vigilant. When deciding whether to buy a stock or not, it is relatively easy to dispassionately analyze the company and its prospects, ignoring the emotional pulls of greed and fear. But in deciding whether to sell that which you already own, the traps are more varied and the emotional tugs stronger in all directions.

There are many different emotional pitfalls to avoid. There is confirmation bias, where a person has the pronounced tendency to see and trust information that conforms to their prior opinions and to discount or reinterpret information that goes against the grain. There is anchoring, where a prior decision on valuation makes it hard to adjust that number greatly in either direction, even as new information becomes available. There is the fear of missing out on future price increases. There is the fear of missing out on locking in gains. There is the fear of looking stupid. (People will do incredibly stupid things so as not to *look* stupid.) There is greed. There is the whole gamut of human emotions, and it is crucial, it is absolutely crucial, that investment decisions are never based on emotion.

At Focus Capital Management, we have a disciplined approach and a clear framework for our selling decisions – what constitutes a good reason to sell and what would constitute a bad reason.

Bad Reasons to Sell

Price Drop

A well-known investing maxim is to "cut your losses". When the price of a stock they invested in goes the wrong way, people bail out and look for a rosier place to invest. I think that this advice makes a lot of sense if your investment plan is based on technical trading, trend following, voodoo, or reading tea leaves. By all means, if the price moves strongly against you, fold and move on to the next cup of tea. But if you are a fundamental value investor, buying companies that you have painstakingly researched and determined to be undervalued, then a price drop that is unaccompanied by a deterioration in the company's underlying business prospects just makes the company even *more* undervalued. That may be a good reason to buy more of the company, but it is certainly a terrible reason to sell it. I would say that the truest test of temperament for a deep value investor is if he welcomes price drops as opportunities to buy more or if instead he gets a pit in his stomach. How an investor reacts to price drops is also a strong test of the investor's conviction and the quality of his research into the company. In short, a price drop that is not accompanied by economic deterioration in the company's underlying value is not a good reason to sell.

Recession

What if there *is* economic deterioration? Time to cut and run, no? Time to admit defeat, lick your wounds, and lose gracefully. Not so fast. Sometimes there is economic deterioration, yet there is still no reason to sell. Just about every company and industry is subject to cycles – the broader economic cycle, industry-wide cycles, and sometimes company-specific cycles. If economic deterioration is to be "expected" and it is *not* an indication of flaws in the original investment thesis, then the investor should stick through it. The economic cycle will inevitably turn and attempts to time when precisely that will happen inevitably fail. It is of dire importance, however, not to fool yourself. You have to constantly test your thesis against the facts, against reality. Do not fall prey to confirmation bias. Ask yourself – if I didn't already own this stock, would I buy it now, knowing what I now know? Avoiding emotional decision-making and correctly distinguishing between a run-of-the-mill cyclical drop and a broken thesis is probably the most difficult job for a fundamental value investor.

Taking Profits

Some investors like taking some profit off the table, either programmatically (e.g. sell half when it doubles, so as to "play with house money") or after a sustained price rise. I do see some benefit for some investors in that it quiets their emotions and allows them to approach the remaining position more rationally. Nevertheless, at Focus Capital Management, we find the negatives to outweigh the positives. It caps the potential of your winners, and unless done programmatically, it often *causes* emotional decision-making, the bane of all successful investing.

Rebalancing

Some investors rebalance their portfolio annually or even more frequently, and there are theoretical academic reasons to favor rebalancing (although more so among sectors or strategies than individual positions). Nevertheless, again we find that the negatives generally outweigh the positives. The more fiddling an investor does with their portfolio, the more they can fool themselves into thinking that they are making reasoned rational decisions, when in truth they are making emotion-laden, seat-of-the-pants decisions.

Finding Something Better

This certainly sounds very reasonable on paper. If you find a better opportunity, a company more deeply undervalued with a better risk/reward profile, it would seem to make sense to switch. Nevertheless, we find that in practice this does not work well. If the original investment thesis is intact and it has not reached near its expected conservative valuation, then it should stay. As you may have noticed, the common thread throughout is to not allow footholds for emotional "thinking" to take over the decision-making process.

Good Reasons to Sell

At Focus Capital Management, we believe in only two good and proper reasons to sell: if the original investment thesis is broken or if the investment has reached its expected valuation.

Broken Investment Thesis

If the original investment thesis is proven false, the stock should be summarily disposed of. This is easier said than done. As the saying goes, the easiest person in the world to fool is yourself. As always, an investor has to be vigilant not to fool himself. When the facts are against your predictions, you cannot invent alternate facts, excuses, or new reasons why the company is a good investment. You can definitely do that, but that won't make you any money in investing. It can be hard to admit that you were wrong, but it's worse not to. Just do it. Admit it, analyze what went wrong and why, and move on, hopefully a better investor for the future.

Reached Valuation

This is, of course, the desired end goal. Buy an undervalued stock, watch as it rises to your expected valuation, and sell. However, although this is certainly a pleasant enough reason to sell, it is still surprisingly difficult to properly implement this. Because when we talk about an investment reaching its valuation, we do not mean the original valuation target when you bought it. True value is a moving target and has to be updated as events unfold. It is extremely common that your ultra-conservative valuation of a stock shows it to be significantly undervalued even if many things go less-than-superb. But often, not everything goes wrong, sometimes some things actually go right. And although the stock rises with the rising earnings, it can remain as undervalued as it was originally or even more so. An investor must avoid anchoring on one specific valuation range that was developed years in the past, before the company in question continued to improve its value.

Our Approach at Focus Capital Management

At Focus Capital Management, we have a 3-pronged approach to selling. One, selling starts with buying. Two, periodic reviews. Three, annual ground-up reassessments.

Selling Starts with Buying

With our deep research and analysis, we strive to reach a comprehensive understanding of the company and what makes it tick. From the moment we buy, we understand precisely why we bought, what we expect to happen, and what future events will confirm or disprove our investment thesis. If you don't know your destination, it is impossible to tell if you're heading in the right direction. Without the deep research-based understanding, you cannot know whether to drop a struggling company or to remain patient through the downturns. And without the conviction based on that understanding, you cannot muster the necessary fortitude to remain patient.

Periodic Reviews

In addition to constant monitoring of industry and company developments, we schedule periodic reviews of each company in our portfolio. With most companies, the natural timetable to schedule these reviews is around quarterly earnings releases. The point of periodic reviews is to be able to take a step back and not get lost in the week-to-week minutiae. To take a step back and see the bigger picture of what progress is being made.

Annual Reassessments

In addition to quarterly reviews, we also periodically reassess the company from the ground up, approximately annually, with a particular focus on valuation. The idea is to look at the company with fresh eyes and question our basic assumptions. If we were starting from scratch and didn't already own this company, would we now want to buy it? Scheduling set times to review a company's prospects and its valuation is greatly helpful in reducing the seat-of-pants approach that often accompanies selling decisions. Selling decisions made on a day-to-day basis are often subject to overreacting to day-to-day news and day-to-day moods and is not the best way to rationally approach selling.

No points for Speed

Finally, as a fundamental tenet of our investment philosophy, including both buying and selling, we do not award ourselves points for speed. We are not attempting to buy at the absolute bottom, nor are we attempting to sell at the absolute top, and we are not at all interested in being first with our hand on the buzzer when news comes out. Any advantage gained by speed is more than outweighed by the advantage in careful consideration, thoughtful analysis, and taking time to mull, digest, and fully absorb events and developments and their implications.

Conclusion

Investing successfully requires an intelligent approach to buying and an intelligent approach to selling. Too often, selling gets treated as an afterthought. At Focus Capital Management, we strive to bring the same reasoned, rational, deep analysis to selling as we do to buying, and we believe this is one of the keys to our success.