

Good reasons to lock in your gains and trim your holdings

Whitney Tilson

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Since I began writing this column in late February, I have made 10 stock recommendations – eight longs and two shorts. All are in the money, with an average gain of 31 per cent, led by Lear Corp, the automotive components maker, which has almost doubled since I wrote in late March that its share sell-off had been way overdone.

With all of the major stock indices up for the year – and in many cases, hitting multi-year highs – many investors are facing the dilemma of whether to lock in similar gains.

There are no simple answers but here are four reasons we generally start to take profits.

The first reason is straightforward – when a stock rises to our estimate of intrinsic value. Let us say we buy a stock at \$10, thinking it is worth \$18-\$22, with a midpoint of \$20 – a proverbial 50-cent dollar. Assuming no change in intrinsic value, we would likely start trimming the position at \$18 and be out by \$22. It is critical, however, not to anchor on the original estimate of intrinsic value. If unexpectedly good news is behind the stock reaching \$18, for example, our estimate of value might have risen to \$24-\$28, in which case we likely won't be selling yet.

This is a major reason we still own a large position in McDonald's, which we bought years ago as low as \$12. We originally thought the shares were worth \$25 or so but, when the price got there, our estimate of intrinsic value had risen to approximately \$35. When it hit \$35, we thought it was worth \$50-\$60, which is why we are still holding at almost \$42 today.

The second reason we sell is when we find a better investment. That may mean selling an 80-cent dollar to buy a 50-cent dollar, or selling a risky stock to buy an equally cheap safer one. The latter explains why we sold Lear after it had rallied into the high \$20s. As I noted in my first column, Lear is in a terrible industry and, if US carmakers encounter further distress, Lear will be hit by a negative impact in ways that are hard to forecast. The stock may well double again, but we cannot rule out the possibility that it could also go bankrupt someday, as have many of its auto supplier peers. We took our profits in Lear and reinvested them in Berkshire Hathaway, which we believe is the safest company in the world and was equally cheap at the time (both stocks are up approximately 30 per cent since we swapped them).

Our third reason for selling is if the story on a company materially changes. We agree with Greenlight Capital's David Einhorn when he says: "We never invent new reasons to

continue with a position when the original reasons are no longer available.” This situation occurs more frequently in losing stocks, but also happens on occasion with our winners.

A few years ago, after making big gains on the stock previously, we got back into shares of EVCI Career Colleges at about \$6, thinking their intrinsic value was \$10-\$12. Then the company announced the most egregious compensation scheme, in which the top two executives would receive annual cash salaries and bonuses equal to 8 per cent of the company’s revenues, plus receive almost 5 per cent of shares outstanding in the form of stock options each year. This shattered two pillars of our investment thesis – the high integrity of management and a competent, independent board – so, after registering our feelings and getting no response, we sold immediately. You will not be surprised to learn that EVCI stock is now under 50 cents.

Finally, we sometimes trim stocks to balance our portfolio. The margin of safety on a big winner typically goes down just as the rising price makes it a larger share of the portfolio, so we often take some profits in the position when that happens. We also do this if a particular sector takes up too much of our portfolio. After making great money on McDonald’s, CKE Restaurants, Jack in the Box and Yum Brands in 2003, we cut back because we did not want too much exposure to burger stocks.

One final caution – do not fall into the trap of consistently selling your winners and buying more of your losers. While this can be the right thing to do, great investors typically have a gift for finding a few great stocks and having the conviction and courage to let them run. In a recent interview for Value Investor Insight, Akre Capital’s Chuck Akre told us that he first started buying Berkshire Hathaway at about \$100 in the mid-1970s. He has made 1,000 times his money – and still holds the stock! Such situations happen rarely in an investment lifetime, so if you think you have found a “compounding machine”, as Akre calls it, think long and hard about ever selling.

Whitney Tilson is a money manager who co-edits Value Investor Insight and co-founded the Value Investing Congress.

E-mail: feedback@tilsonfunds.com