HUTCHINSON
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INVESTMENT PERSPECTIVES

<u>Hope For the Best…Plan For the Worst</u>

"When the facts change, I change my mind. What do you do sir?"
--John Maynard Keynes

"Hope" is not a word you'll hear from us when it comes to investing your money, but planning, on the other hand, is deeply embedded in the culture of Hutchinson Capital. In this *Investment Perspectives*, we want to share with you the efforts involved in arriving at a sell decision. By the time you receive a confirmation slip alerting you to the sale of a position, much has occurred behind-the-scenes at HCM.

"*Stock selection, valuation, and diversification are the building blocks of risk management, but a sell discipline is the glue that holds them all together."*[1]

When we are considering a new investment we always think in terms of owning the whole business, and owning it forever. The reality is that, before we even buy a stock, we have already planned for future contingencies that may force us to sell it. While we would be overjoyed if every company we bought was a perpetual value creator and never had to be sold, the truth is that such companies are extremely rare. Because of this, we must think of stocks in the cold reality of their economic utility: we buy stocks in order to sell them. A common sell strategy employed by value managers includes target price or valuation-based selling. This means buying a stock at a low price-to-earnings (P/E) multiple and selling the stock when it recovers to its long term average P/E. We also employ a valuation-based target sale methodology as part of our investment planning, but with our own variations.

Part of what drives the sell decision, hence the portfolio turnover[2], is the nature of the methodology governing the purchase decision. For us, running a portfolio of 20-30 deeply researched companies means our purchase decisions are very deliberate. Because we expect to forge a long-term relationship with each stock we buy, we are extremely discriminating in the company we keep.

But what happens when the facts change and we change our mind about a stock? How do we decide when to sell? What do we actually do and what are the implications of making this decision? Generally, there is a singular investment reason for us to sell, but many other factors

[1] Vitaliy N. Katsenelson; *Active Value Investing: Making Money in Range-Bound Markets*; 2007 by Wiley Finance
[2] Turnover is a measure of trading activity within the portfolio over a set period of time, generally one year; a turnover ratio of 20%, means that, in an average year, 1 out of 5 stocks is replaced; said another way, each stock is held for an average of 5 years.

will have been taken into consideration well in advance of our actually entering the trade. Much depends on the primary issue: why are we selling the stock?

1. ***Has it reached our price target or was our analysis wrong?***

2. ***Have we found a better opportunity?***
   - If the answer is YES, we should already be prepared to redeploy the proceeds into that new stock
   - If the answer is NO, what are we going to do with the cash?

3. ***What are the tax implications of the sale?***
   - The investment decision always comes first, but we prefer to be tax efficient as well

4. ***Has the stock's relative size grown to the point where the position must be reduced?***
   - One of our risk management policies is to reduce any position exceeding 10% of the equity portfolio value

Those are all practical, financial implications of the sell decision, but there are other, more subtle factors with which we contend. Under the surface there are emotions attendant to selling that are vastly different from those arising from the purchase decision. It's exciting and inspiring when we find a new idea to buy, while it's often disheartening to conclude that a stock won't be with us forever. Stocks that have worked, that have gone up, make us feel good, and severing those ties can be emotionally difficult. But stocks don't have feelings; they don't know when we sell them. Stocks are merely tools to increase your wealth. The growing field of *Behavioral Finance* is one in which we find quite a lot of validity. At its core, behavioral finance seeks to unravel why human beings make the decisions they do, because investment decisions clouded by emotions result in errors. We have spoken about our need for other investors to make mistakes, but we haven't spent much time explaining how we avoid such errors ourselves. Because we're covering sell decisions in this paper, we'll discuss those behavioral traits most closely related to selling.

- ***The Disposition Effect***: This trait is more common among professional investors and is built on the theory of Mean Reversion.[3] It is motivated by the feeling that all unrealized gains are fleeting. The desire to lock in gains based on price appreciation, irrespective of changes in value, often results in selling good stocks too soon. Falling prey to this error has led to the familiar investment expression: *"Sell your losers, and let your winners run."*

- ***The Endowment Effect***: This trait affects professionals and non-pros alike. It stems from the fact that people like the safety and security of things familiar. It affects investor behavior because it causes them to place a higher value on things they know, ignoring the monetary value. It also relates to another behavior known as *Confirmation Bias*, an emotion which feeds the human desire to hear their own beliefs confirmed by others. It's seen in the comfort many investors get from speaking with company management. Management is viewed as the ultimate authority within the companies they govern, and they are deft at making investors feel good about their ownership.

  A tangible example of The Endowment Effect would be the following: Suppose that several years ago you bought a bottle of wine for $10 and today it's worth $100. Given

[3] Mean Reversion is the process by which changes that move returns substantially above or below average must reverse and return to average.

> the option to buy more at $100 per bottle, or sell your current bottle for $100, most people answer that they would do neither, opting to just keep the bottle they own.[4] This decision/non-decision is **economically irrational**, but it probably makes sense to you for reasons you can't quite explain. The wine can have an intangible value that cannot be put into dollar terms—stocks should never have such value to an investor. This is why emotions can be so pernicious and their effects so elusive to investors. This also demonstrates the human tendency to place a higher value on things already owned.

At HCM, we count among our competitive advantages our willingness to be introspective. By fostering a culture of curiosity, we assess our past mistakes without fear of recrimination. We perform a forensic evaluation of all of our decisions to avoid repeating past mistakes. This self-awareness, coupled with documentation, helps us separate experience from memory. This is crucial to us because we want our knowledge and deep research process to give us conviction, but without the emotions that might cloud our objectivity.

Renowned chemist, Louis Pasteur, was fond of saying that, *"…chance favors the prepared mind."* At HCM, the conclusion to sell a stock is not arrived at whimsically; we constantly monitor each position in the portfolio, and all new information that affects our stocks is immediately incorporated into our investment thesis and Intrinsic Value[5] calculation. Because of this vigilance, we are always prepared to respond to any abnormal price gyrations among the stocks in our portfolio. When one of our positions has a particularly large upward move in price, there are three alternatives available to us: (1) Do nothing; (2) Sell part of the position; (3) Sell the entire position. Each of these three decisions stems from different causes, with each resulting in distinctly different actions. While each of these three options is unique, once the price of a stock has risen by some meaningful amount, its sheer magnitude reduces our diversification and increases the risk of the overall portfolio.

If the stock price appreciation is accompanied by an improvement in fundamentals, causing an upward adjustment to our Intrinsic Value, we may not take any action. If we believe the price move is unsupported by fundamentals, is only temporary, or has caused the position to grow disproportionately large, we might reduce the position. If the stock price vastly exceeds our Intrinsic Value and we see no current or future fundamental reason to raise our target value, we will sell the entire position. We are bombarded daily by a slew of new information, from which we must segregate genuine news from noise. The bulk of news flow is inconsequential, but once in a while, we sift out a genuine signal of fundamental change. Knowing the difference is part art and part science.

In the 1960's, the average NYSE investor holding period was 7-8 years; today that number is less than nine months. This means trading activity and turnover among market participants is much higher. Our market research suggests that the movement of share prices over a period of less than three years is predominantly random and more a function of luck than skill. So what's changed between the 1960's and today that has caused these tectonic shifts in the investment landscape? We believe the root cause is an increase in the volume of information and the ease with which it is acquired. With more information, investors feel more confident. But confidence and conviction alone do not improve investment results. And it's not just the investment managers who have been susceptible to this risk, it's also their clients. Fund managers invest based on the desires of their clients, so the conclusion must be that clients are allocating increasing amounts of capital to managers employing more speculative investment strategies. This pressure from clients

[4] James Montier; *Behavioural Investing*; 2007; Wiley Finance
[5] Intrinsic Value is the total fundamental value of the franchise including both tangible and intangible assets

explains the explosion of growth in computer-driven strategies; in such strategies, success is defined by the ability to absorb massive volumes of data and execute with lightening speed. We don't directly compete against these asset managers so why do we care about their behavior? We care because these funds are large and their actions impact stock prices. Because of their size, the basis upon which they compete with each other, and the velocity of their trading activity, they can temporarily push stocks well away from Intrinsic Value.

Over the many years we've written to you, we have often used the words "Patience" and "Discipline," but what do we actually mean when we apply them within the context of managing your portfolio? Patience is a function of the investment horizon needed to implement the investment strategy we apply on behalf of our clients. This requires patience because we must manage the portfolio through periods of significant price gyrations that are, more often than not, unrelated to fundamentals. We know this because there's evidence that stock prices are 15 times more volatile than the changes in fundamental value. This knowledge does not obviate our obligation to analyze and understand the forces behind the changes in stock prices.

This duty of constant oversight and analysis, despite the predominance of noisy false alarms, leads us to the notion of discipline. An investment strategy built on patience, and enforced through discipline, enables us to carefully assess information and then apply our competitive advantages toward making the best decisions on behalf of our clients. But how do we do it? Through years of experience, accumulated knowledge, valuable relationships, and the application of proprietary systems, we distill the mountains of information available on a company into the few critical drivers that truly influence the value of the franchise. Armed with this knowledge, and, coupled with the means to track these critical drivers, we are able to differentiate genuine signals from noise. We understand that amid the growing sea of data, the only important information is that which pertains to these critical factors underpinning the company's business. It takes discipline to assess all the data, observe the often violent stock price reactions, but only act when it's absolutely necessary.

Risk experts in the world of finance use sophisticated theories like *Exogenous Risk* and *Endogenous Risk* to explain the different forces influencing stock prices. We have a simpler way of explaining it. While we think of investing as a vastly different endeavor from speculating, we'll use a gambling analogy to illustrate the importance of psychology in investing. Consider the differences between Roulette and Poker: Roulette is purely a game of chance, where the actions of other speculators have no effect on the player's own outcome. Poker, on the other hand, requires constant attentiveness to the behavior of competing players. Most risk models, and computer-driven investing strategies can only think in Roulette (Exogenous) terms, meaning they consider the risk of the stocks they own only in terms of what their own actions mean to portfolio risk. At HCM, we think of risk in Poker (Endogenous) terms. We believe that it's important to understand how the actions of other players affect the risk of our portfolio. An example of how Endogenous Risk impacts us, in practical terms, occurs when one of our stocks appreciates meaningfully. Through the actions of others, the rise in market value of an individual company increases that stock's concentration in the portfolio, and thus our risk. This means we must endeavor to understand why it's occurred and whether the appreciation is justified and sustainable. This is a link in an elaborate chain that forms a feed-back loop in our sell decision process.

"Quality" is another word you often hear from us. When it comes to quality, we've frequently told you <u>what</u> is important, but we've rarely discussed <u>why</u> it's so important. Only quality franchises are capable of continually reinventing themselves in ways that allow for perpetual increases in value creation. Even though we acknowledge their rarity, we will always invest with the expectation that each of our companies will have the capability to be a continual value creator.

Conclusion

While we always seek to buy what is inexpensive and sell what is overvalued, the process of buying and selling are **not** flip-sides of the same coin. The differences are both practical and emotional. Before a sell decision is made we will have already considered the tax ramifications as well as what we expect to do with the cash proceeds. But equally important are the emotional differences; buying a stock is like entering an exciting new friendship, whereas selling is the severing of what may have been a long and rewarding relationship. But stocks are not friends—it's a one-way relationship in which we only care about what that stock can do for us economically. When it comes to investing, it's important not to let those lines blur.

For a complete list of holdings, please see our most recent 13F filing on the following SEC website: http://www.sec.gov/edgar/searchedgar/companysearch.html

This information reflects our subjective judgments and assumptions, without regard to unanticipated market or other events that may occur. Therefore, there can be no assurance that events will unfold as discussed, or at all. HCM's investment decision making process involves a number of different factors, not just those discussed in this document. This material reflects the opinion of HCM professionals on the date made and is subject to ongoing evaluation. Our opinions could change at any time and HCM has no obligation to update this material on any particular timetable, or at all.

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