Trim or Sell? Which Is Better for Your Portfolio?

BetterInvesting National Convention

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Session: 148

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Content

- What is trimming?
- Some reasons why selling is tough.
- If it is time to sell – should you sell it all or just trim?
- Trimming might help long term returns.
- Economic moats – What are they?
- Guidelines to trim a holding.
- Summary

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The Concept of Trimming

- Definition – Trimming is where you sell a portion of your holding and let the rest of the holding run.
- Many investors spend a lot of time trying to figure out their losers and less time on their winners.
- You can automate this process for winners.
- Assume we are looking to trim high quality stocks as identified on the SSG.

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Every Day an Investor Has Four Options

1. Sell your shares
2. Buy more shares
3. Nothing
4. Trim

Source: Charles Schwab, 8-9-2021.

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We Want to Find These Kinds of stocks - AMZN

If you sold everything at any of these points, you missed a lot of future gains – yet you made good money. **This is risk of selling it all!**

Source: Charles Schwab, 8-9-2021.

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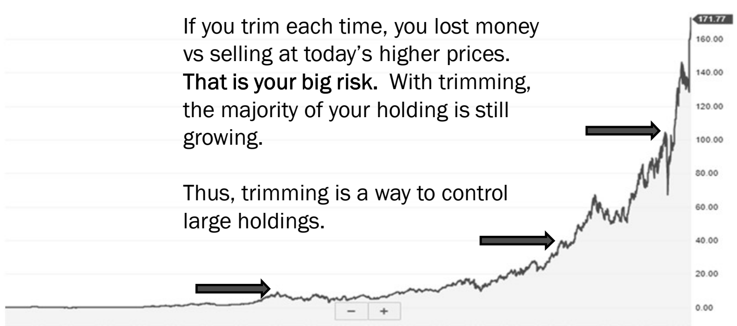
We Want to Find These Kinds of stocks - NKE



If you trim each time, you lost money vs selling at today's higher prices. **That is your big risk.** With trimming, the majority of your holding is still growing.

Thus, trimming is a way to control large holdings.

Source: Charles Schwab, 8-9-2021.

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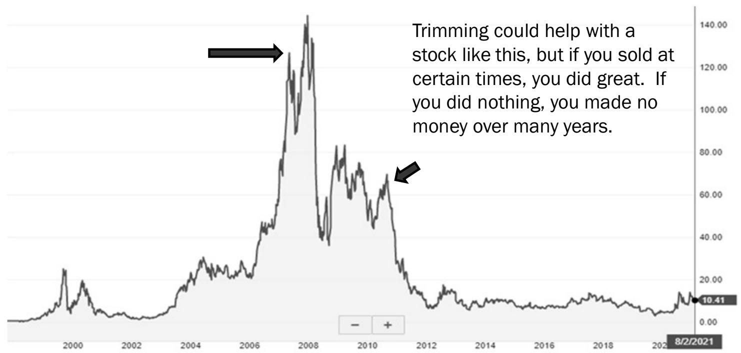
The Risk of a Big Winning Stock

- Large single stock positions can impact your returns significantly if that stock goes bad.
- Examples – GE, JC Penney, Lehman and WorldCom.
- Trimming can help you control the size of big winning positions and raise some cash for diversification. Could have helped with Zoom Video.
- If you sell it all, you have to try and find a replacement. You have to make 2 right decisions.

We Want to Avoid These kinds of stocks - BB

Trimming could help with a stock like this, but if you sold at certain times, you did great. If you did nothing, you made no money over many years.



Source: Charles Schwab, 8-9-2021.

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What About These Kinds of stocks - AMGN

- This is a challenge – over 10 years of no stock appreciation.
- Do you have the patience?
- Trimming might help you wait for the stock to start going up again.

Source: Charles Schwab, 8-9-2021.

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Summary of These Charts

- It is easier to look backwards and say has it been a good stock.
- It is easier when I give you the name of the stock.
- We are assuming we are looking at high quality stocks.

- It is a lot harder to say, “What do you do now?
- Consider your SSG for guidance at each decision point.
- The last chart on Amgen is a great example….

- Let’s try a couple more!

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What Do We Do Now?

Check out your SSG!

Source: Charles Schwab, 8-9-2021.

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What Do We Do Now?

Check out your SSG!

Source: Charles Schwab, 8-9-2021.

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Selling Is Tough

- People don't like to admit they made a mistake.
- Fear of Loss AND Fear of Regret.
- Want to get out and get "even" if they are at a loss.
- There is no precise mathematical formula.
- If you sell now, you miss out on the future.
- You lost money.

Many psychological issues with selling.

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Some Reasons Why You Should Sell or Trim

- The long term outlook for the company is unfavorable
- Deteriorating corporate financial condition

Probably sell

- *Temporary declining profit margins*
- *Adverse management change*
- *Increasing competition impacting profits*
- *Dependence on a single product*

Trim or sell

- High valuation of a quality stock
- Position size has become too large – this is a risk too

Trim

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My History with Trimming vs Selling

- Here is a list of stocks from my personal clubs that have grown +500% over time. These companies are: NKE, ATVI, BDX, DIS, MCD, COST, GOOG, AAPL, ISRG, SBUX, DOCU.
- Many of these have been trimmed several times, despite having strong economic moats.

I want to own this kind of a chart.

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So Why Trim Versus Sell?

- It is my desire to own my stocks forever – as long as they are executing. Thus, I lean toward trimming vs selling.
- My biggest factor is whether the stock has a wide economic moat.
- No moat, I look to sell.
- Why? <u>Not many long term winners vs the market. Not many wide moat stocks</u>.
- The goal is to control the position size. Risk reduction.

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In the Long Term

- As an investor, I'm doing research to find information that confirms or denies my beliefs about a company's moat or business model.
- If it continues to execute, keep owning it!
- There are not many successful companies that last over several decades. Thus, you might have to sell.

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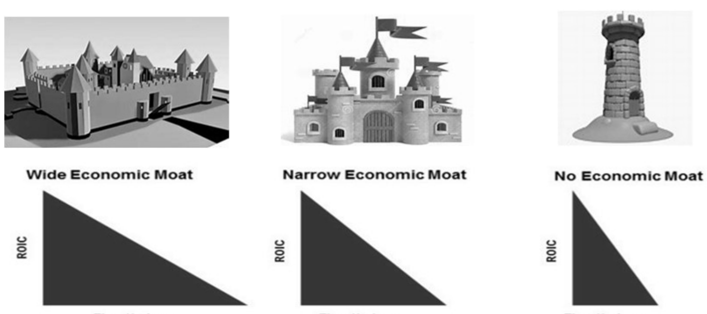
Economic Moat Thought Process



Source: Pat Dorsey, Morningstar.

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Moat Performance – Wide Moats Win

Market Performance by Moat Rating and Moat Source ■ Top Performer ■ Bottom Performer

	Number of Companies	Median Annlzd 5 Yr TR (%)	Mean Annlzd 5 Yr TR (%)	Median Annlzd 10 Yr TR (%)	Mean Annlzd 10 Yr TR (%)
Morningstar Coverage Universe	1,503	13.7	13.2	7.3	6.8
Moat Rating					
Wide-Moat Companies	209	**15.7**	15.6	**10.6**	**11.0**
Narrow-Moat Companies	643	15.5	**16.0**	8.6	9.0
No-Moat Companies	651	10.5	9.6	3.3	2.9

Source: Morningstar Magazine, August / September 2017.

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Moat Analysis

- The potential of wide moat stocks are intriguing.
- Wide moat stocks should have higher margins over a longer timeframe.

Moat Rating	Number of Companies	ROIC TTM (%)	ROIC Trailing 3 Yr (%)	ROIC Trailing 10 Yr (%)	Operating Margin Trailing 10 Yr (%)	Net Margin Trailing 10 Yr (%)
Wide	209	12.5	13.5	19.0	21.1	14.1
Narrow	643	9.0	9.7	14.8	14.7	9.0
None	651	5.1	4.8	8.6	7.6	4.4

Source: Morningstar Magazine, August / September 2017.

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Evaluating Management SSG Style – Narrow vs Wide Economic Moat

Evaluate Management — Narrow Moat

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	5 Yr Avg	Trend
% Pre-Tax Profit on Sales	8.1%	11.0%	12.6%	12.3%	12.7%	12.9%	13.5%	13.4%	12.8%	12.2%	13.0%	
% Return on Equity	8.7%	10.1%	12.1%	10.9%	10.8%	11.5%	14.0%	16.9%	17.7%	18.8%	15.8%	
% Debt To Capital	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	50.5%	10.1%	

Evaluate Management — Wide Moat

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	5 Yr Avg	Trend
% Pre-Tax Profit on Sales	57.5%	61.6%	21.2%	61.6%	60.8%	64.8%	53.1%	63.7%	62.1%	64.8%	61.7%	
% Return on Equity	11.1%	13.0%	8.0%	17.8%	19.5%	21.9%	22.0%	24.8%	35.1%	40.1%	28.8%	
% Debt To Capital	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	32.5%	35.9%	32.8%	32.5%	26.7%	

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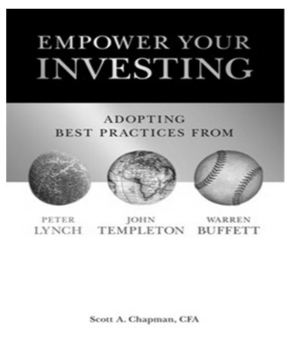
Some Other Thoughts

- Valuation is not my primary reason to trim.
- Managing risk is the goal.
- "Letting my winners run!"
- The key is whether the stock has a wide moat.
- I've used this book as a framework for how I invest.



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Morningstar's Sources of Sustainable Competitive Advantage

These can create economic moats

Source: Van Eck

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Definitions of Competitive Forces

Economic moat is a sustainable competitive barrier against competition.

- **<u>Network Effect</u>** – When the value of a product or service grows as its user base expands. Each additional customer increases the product's or service's value exponentially. *<u>It is perhaps the strongest type of economic moat.</u>*
- **<u>Switching Costs</u>** – When a company has pricing power by locking customers into its unique ecosystem, they have high switching costs. Payroll processing is an example.

Source: Investopedia, Morningstar.

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Definitions of Competitive Forces

The key of an economic moat is how long a company will keep competitors at bay.

- **<u>Intangible Assets</u>** - A broad category that includes brands, patents, and regulatory licenses.
- **<u>Low Cost Advantage</u>** – Ability to offer lower prices than your competitors for the same product or services.
- **<u>Economies of Scale</u>** – Lower cost advantage typically comes from size or scale or "The Largest Player" in a smaller sector. Spread the costs over your size.

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Source: Investopedia, Morningstar.

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Question Time

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The Trimming Evolution

- I've been using a trimming policy since 1990.
- Theory - stocks don't move in a straight line.
- Learned this with my first club.
- Managing risk is the goal. Concern about position size.
- Is this a wide moat stock?

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Mechanical or Manual Process

- Manual, you select your levers each time.
- Since my goal is managing risk, I focus on portfolio weight and capital gain.
- The bigger the weight, the more often I want to trim.
- How much to trim is your choice.
- 5%, 10%, 20%, 25% or more? *I have used 10% or 20%.*
- I prefer mechanical, then discuss in club.

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Mechanical Trim Example

- I trim when a position size is greater than 2x the average portfolio weight. **Assuming I don't want to just sell out.**
- A 15 stock portfolio = 6.67% average weight
  (100% portfolio weight/15 stocks)
- 2x Average Weight = 13.3%.
- **TRIM** if the largest weight is greater than 13%.
- Remember, position weights in the portfolio are relative to the performance of all of the stocks in the portfolio.

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Combined Lever

- First lever is the stock's portfolio weight greater than 2x average portfolio weight.

<u>AND</u>

- Second lever says the stock has a gain of at least 60%, or you would not trim.
- You could use any percent gain and <u>easy to do in excel.</u>

Focus on wide moat stocks and hope to own forever.

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The Excel Formula – Relative Weight and Performance

	Cost per Share	INVESTMENT GROUP Current Price	Current Value	% in Investment	% Gain/Loss	Target Price	Above Target Price	Purchase Date	Trimming Events
ATM	30	95	41,994	6.5%	217%	122	no	11/11/08	Twice
GOOGL	577	2442	58,603	9.1%	323%	1478	Maybe	3/25/13	Once
AAPL	4	150	75,600	11.7%	3468%	146	yes	2/4/08	Fifth
BRKB	52	278	61,142	9.5%	430%	84	Maybe	5/21/97	
SCHW	26	73	83,732	13.0%	182%	66	yes	7/22/97	Once
ISRG	216	920	83,687	13.0%	326%	553	yes	3/21/16	Once
NKE	3	154	61,796	9.6%	5421%	18	Maybe	3/30/94	Fourth
DIS	26	176	44,294	6.9%	570%	134	Maybe	12/30/88	twice
			=========		**$67,803**				
			644,130		**11%**	2x Weight			
					5.3%	Avg. Wgt			

Source: Craig Braemer's Bullpen Club Portfolio, 6/30/2021.

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The Formula – Relative Weight and Performance

=IF(current price>Target Price, IF(% in Portfolio> 2X Avg. portfolio weight, ”Yes”, ”Maybe”),”No”)

- My definition of the target price = cost plus 60% or 100% gain.
- Issue with small positions - must grow to big weights prior to trimming. Small positions don’t impact performance as much as large positions.

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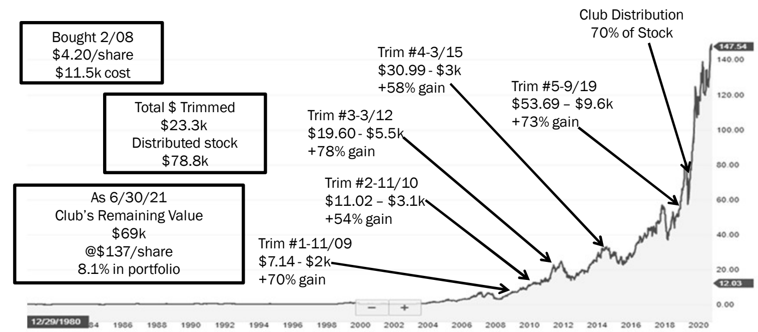
Example: Apple – Five Trims + One Distribution vs Selling



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How Much Should You Trim?

- It is your choice, but I recommend 10% and 20%.
- Big enough to reduce the weight. Capture long term returns.
- Great long term potential vs taking some money off the table.
- This is the discussion with our mechanical system.
- Every trim done, runs the risk of missing out and just selling everything at the peak.
- Easier to sell small amounts. Less stress.
- Tough to identify the peak.

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I Think Trimming Works – Can I Own My Stocks Forever?

- I would like to own my stocks forever. Thus, strong SSGs and economic moats are my focus.
  - SSG Sections 1 & 2 are great at analyzing business models.
  - I want to own good models over time.
- However, forever isn’t realistic. At some point, some stocks will have to be sold.
- Many leaders don’t stay at the top forever.
- We only own 10-25 great stocks – we have a big advantage.

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Top Market Cap Stocks per Decade

@CharlieBilello — Largest Companies Globally by Market Cap (1980 - 2018)

Rank	1980	1990	2000	2010	2018
1	IBM	Nippon Telegraph & Telephone	Microsoft	PetroChina	Apple
2	AT&T	Bank of Tokyo-Mitsubishi	General Electric	Exxon Mobil	Amazon
3	Exxon	Industrial Bank of Japan	NTT DoCoMo	Microsoft	Microsoft
4	Standard Oil	Sumitomo Mitsui Banking	Cisco	ICBC	Alphabet
5	Schlumberger	Toyota Motors	Walmart	Walmart	Berkshire Hathaway
6	Shell	Fuji Bank	Intel	China Construction Bank	Facebook
7	Mobil	Dai-Ichi Kangyo Bank	Nippon Telegraph & Telephone	BHP Billiton	Alibaba
8	Atlantic Richfield	IBM	Exxon Mobil	HSBC	Tencent
9	General Electric	UFJ Bank	Lucent	Petrobras	JPMorgan Chase
10	Eastman Kodak	Exxon	Deutsche Telecom	Apple	Johnson & Johnson

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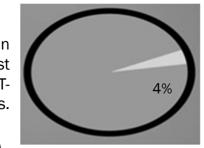
Are Holding Individual Stocks Irrational?

DO YOU IRRATIONALLY HOLD POSITIONS IN INDIVIDUAL STOCKS?

Since 1926, 4% of the stocks explain the stock market returns. The rest had returns similar to one month T-Bills.



42.6%
26,000 COMMON STOCKS
1926-2016

Yet Club and BetterInvesting investors continue to perform well over time.

42.6% of stocks had return similar to a one month T-Bill.

40% of stocks had a negative return. 67% of stocks underperformed their index.

Source: Ben Felix, PWL Capital.
Picking Stocks | Common Sense Investing. YouTube video – 12/15/2018.

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Leaders Do Not Stay on Top Forever

- This is an advantage of trimming.
- In many cases, you might have to sell eventually.
- Not all stocks will be winners - You have to be selective.
- Trimming can help let your winners run and still pull some money out.

Focus on the strength of the economic moat.
SSG Sections 1 & 2 are good at analyzing economic moats.

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Economic Moats = Business Models = SSG

As an investor, I'm doing research to try and find information that either confirms or denies my beliefs about a company's moat.

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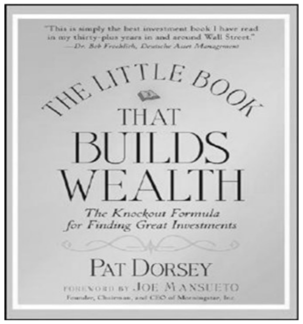
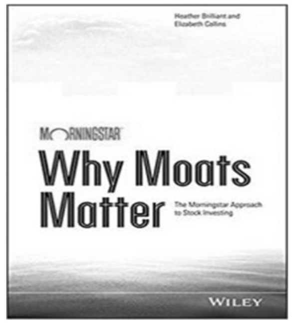
If You Want to Learn More on Economic Moats?





To obtain economic moat information – online libraries that subscribe to Morningstar or available from Schwab.

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Summary

- Trimming should help let your winners run and control your position size. This has helped me hold on to great long-term winners. I call this process - Buy & Manage.
- Sell when you think the future is poor. Remember, not all stocks will win over the long term, but trimming might help.
- Trimming doesn't identify when to sell.
- Wide Economic Moats or "Quality from the SSG" stocks help identify good business models for the long term.

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Question or Comments?

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