

# Dealing with Stocks in the 'Maybe' Zone

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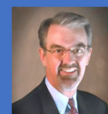
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## In This Session



- How often are you 100% confidence in your decision to buy stock for portfolio, or in decision to buy, sell, or hold current holding?
- Key strategies for coping with uncertainty about investing decisions to buy, sell, or hold.
- 4 portfolio baskets to use in sorting uncertain companies & deciding upon action.

## Buy, Sell, or Hold in Your Portfolio?



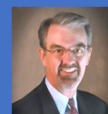
- Classic system of portfolio management seems so clear-cut.
- 3 choices for every security – all you have to do is choose 1 action from the 3 choices!
  1. **Buy:** stocks that you believe have satisfactory future upside potential.
  2. **Sell:** stocks that you believe have significant chances of declining.
  3. **Hold:** stocks that you believe are worth holding for potential upside & low chances of significant declines...**MAYBE**.

## To Buy or Not to Buy New Stock




- 2 conclusions in researching & reaching conclusion on potential new holding:
  1. **Buy now.** Price looks good & fundamentals are strong.
  2. **Don't buy now.** Price looks high and/or fundamentals are “iffy.”
- In practice, stocks that you don't find immediate buys might be buys if price or fundamentals improve...**MAYBE**.

## Maybe Zone on Original SSG



- 3 zones on original Stock Selection Guide were:
  - BUY
  - **MAYBE**
  - SELL
- SSG Plus now calls **MAYBE** zone the “HOLD” zone.

## Maybe Zone on Original SSG



**4 EVALUATING RISK and REWARD over the next 5 years** (4C2) Lower 1/3 = (4B1) to \_\_\_\_\_ (Buy)

Assuming one recession and one business boom every 5 years, calculations are made of how high and how low the price will be over the next 5 years.

**A HIGH PRICE -- NEXT 5 YEARS**

(4C3) Middle 1/3 = \_\_\_\_\_ to \_\_\_\_\_ (Maybe)

Avg. High P/E \_\_\_\_\_ X Estimate High Earnings/Share \_\_\_\_\_

(3D7 as adj.)

**B LOW PRICE -- NEXT 5 YEARS**

(4C4) Upper 1/3 = \_\_\_\_\_ to \_\_\_\_\_ (4A1) (Sell)

(a) Avg. Low P/E \_\_\_\_\_ X Estimated Low Earnings/Share \_\_\_\_\_

(3E7 as adj.)

(b) Avg. Low Price of Last 5 Years = \_\_\_\_\_ (3B7)

(c) Recent Severe Market Low Price = \_\_\_\_\_

(d) Price Dividend Will Support \_\_\_\_\_ = \_\_\_\_\_ = \_\_\_\_\_

Selected Estimate Low Price \_\_\_\_\_ High Yield (H) \_\_\_\_\_ = \$ \_\_\_\_\_ (4B1)

**C ZONING**

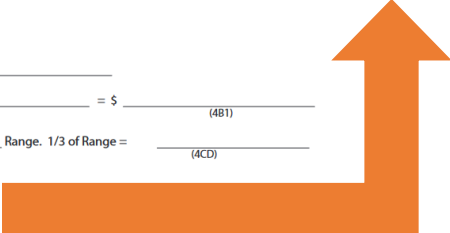
(4A1) High Forecast Price Minus \_\_\_\_\_ (4B1) Low Forecast Price Equals \_\_\_\_\_ (C) Range, 1/3 of Range = \_\_\_\_\_ (4CD)

(4C2) Lower 1/3 = (4B1) to \_\_\_\_\_ (Buy)


(4C3) Middle 1/3 = \_\_\_\_\_ to \_\_\_\_\_ (Maybe)

(4C4) Upper 1/3 = \_\_\_\_\_ to \_\_\_\_\_ (4A1) (Sell)

Present Market Price of \_\_\_\_\_ is in the \_\_\_\_\_ (4C5) Range



## “MAYBE” Zone Is Not Same as “HOLD” Zone



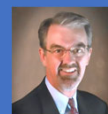
- Original “MAYBE” zone suggests that each person perceives different attributes that would impact decisions, such as:
  - Different judgment applied about future prospects.
  - Whether stock held in taxed or tax-advantaged account.
  - Whether gains/losses if sold would be short- or long-term.
  - Understanding of external issues affecting company.
  - Impact of sale on portfolio diversification.
  - General uncertainty about company or stock valuation.

## Stock Investing Decision Trade-offs



- Multitude of factors come into play when researching stocks.
- Strive to find opportunities driven by tailwinds **despite** evident headwinds.
- Huge warning sign is when **everything** looks good about an investment.
  - Sure sign that something has been missed or analysis is overly optimistic.

## Problems with Inaction Driven by Uncertainty



- Confidence leads to action, but uncertainty causes inaction.
- But paralysis driven by uncertainty is detrimental to portfolio performance.
  - We hold on to underperformers too long, worsening returns.
  - We hold on to outperformers too long, worsening returns.
  - We don't buy when we should, missing opportunities to improve returns.

## Acknowledge Uncertainty



- Uncertainty is inherent in process of investing & analyzing stocks.
- Investors should accept that they are seldom 100% “certain” about any investing decision.
- **Always acknowledge that investing decisions are based on weighing positives & negatives.**
- So how can you resolve uncertainty about stocks in MAYBE zone?

## How to Handle Uncertainty

## The Oracle of Omaha & His Mentor Say...



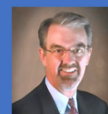
*“The three most important words in investing are **margin of safety.**”*

-Warren Buffett

*“Buy stocks the way you buy groceries, not perfume.”*

- Benjamin Graham

## Build in Margin of Safety in All Decisions



*“You don’t try to buy businesses worth \$83 million for \$80 million. You leave yourself an enormous margin. **When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000 pound trucks across it. And that same principle works in investing.**”*

-Warren Buffett

## Finding Margins of Safety when Buying



- Margins of safety can be found on SSG:
  - Buying at lower than average P/E can reduce risk of price declines.
  - Buying above average profit margins can reduce threats from competitors, industry-wide problems, economic downturns.
  - Buying lower debt/higher interest coverage reduces risk of rising interest rates & resulting lower profits.
  - Buying strong cash flow supports dividend expansion.

## Finding Margins of Safety in Portfolio



- Balance portfolio by sector/industry to reduce risks from overall economy & industry problems.
- Balance portfolio by company size/EPS growth rate to reduce risks of underperforming market & decrease volatility.
- Consider also balancing holdings by **confidence levels** so that average certainty still provides margin of safety.

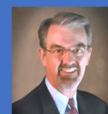


## Consider Certainty as Portfolio Metric



- **Try this exercise:** Evaluate current holdings by confidence/certainty level.
  - Assign 1-to-10 rating to each stock based on how confident/certain you are about its future performance potential.
  - In club, ask each member to rate each stock.
  - Collate results & consider overall confidence level for each holding & overall portfolio.
  - Ideally you should have more stocks with greater confidence than those with lesser.

## Coping with Uncertainty Driven by Price



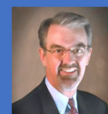
- Stock's valuation will reflect impact of company weakness – **perceived** problems as well as **actual** problems.
- But slight *perception* of weakness can drive price of stock down.
  - Thus, price declines can be deceptive or indicate no severe underlying or long-term problems.
- Often this is most difficult variety of uncertainty to deal with.

## Coping with Fundamental Problems



- BetterInvesting teaches to focus on problem stocks in portfolio as top priority.
  - Companies with slowing growth, declining profitability, management issues, etc., can cause portfolio to deliver sub-par returns.
- Regularly replacing weaker companies in portfolio can boost long-term performance.
- However, can be hard to differentiate temporary company problems from more serious ones.

## Identifying Company Problems



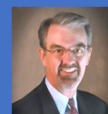
- Company problems typically fit into 3 categories:
  1. Temporary problems that resolve quickly.
  2. Temporary problems that turn into permanent problems.
  3. Permanent/long-term problems.
- Use logic & experience to evaluate & sort into one of these 3 baskets
- You may not easily be able to determine precise fit with these categories, but you can make educated guess about general disposition.
- **If still unsure, can you find stocks that stimulate more confidence?**

## Put Problem Stocks On Probation



- Companies experiencing fundamental problems that don't demand immediate action should be put “**on probation.**”
  - Often have highest levels of uncertainty.
  - Can be prudent to **not** rush into action.
- BetterInvesting recommends that stocks be sold after 3-5 declining quarters of weakness.
- Set plan for re-assessment during this period.

## Coping with Irrational Exuberance



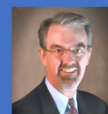
- Often, underperformers may appear to be “good values.”
- But problems can quickly turn “bargain” stocks into “out of business” stocks.
- In other cases, prices may reach historically-high levels (as measured by P/E).
- Market loves success stories & may carry these along at excessively-high valuations for some time.
- Often best to hold overvalued stocks during overvalued markets, but at other times should replace when they reach historically-high valuations.
- However, exercise care whenever holding over-priced stocks.

## Coping with “Too Cheap” Stocks



- Stocks with high levels of general uncertainty tend to be priced “reasonably” with respect to their past results.
- However, discounted price may still be too expensive if anticipated worst-case scenario actually happens.
- Excessively cheap stock (such as if Relative Value is  $< 80\%$ ) are usually sign that company is facing serious fundamental problems.
  - Review fundamentals carefully.

## Coping with Valuation Issues



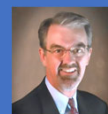
- After dealing with fundamental problems in portfolio, BI suggests turning to valuation issues.
- “**Hypervalued**” stocks are at risk of quickly declining, thus decreasing portfolio returns.
  - Stocks with low projected returns will drag down portfolio returns.
- Often fine to hold overvalued stocks during periods of high market valuation, but bear markets usually arrive without announcement.

## Dealing with Hypervaluation

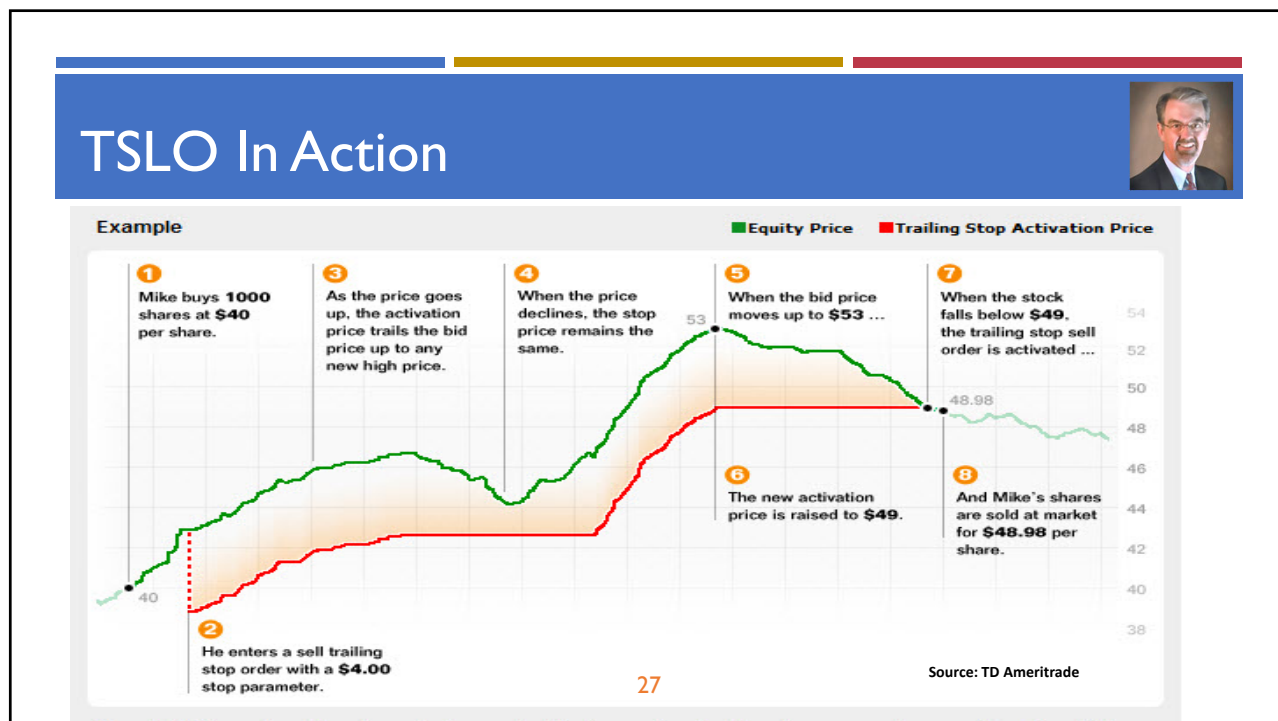


- Once stock has been identified as hypervalued, instead of selling outright consider using trailing stop loss order (TSLO).
- TSLO allows stock to continue run-up but triggers sell if price starts to retreat.
- Common TSLO range is 5%-8%, but review 52-week price chart to see how much price dropped in short periods.

## Trailing Stop Loss Order Basics



- Stop price can be set in 2 ways:
  - As percentage of current price.
  - As fixed dollar amount less than current price.
- Stop price goes **up** as stock price goes **up**, but **does not decline** when stock price declines.
  - Thus if stock continues irrational rise, stop price also goes up.
  - If stock prices goes sideways, stop price remains same.
  - If stock falls, stop price remains same – UNTIL stock hits stop price, then sale is triggered.



## TSLO Warnings

- Only use on stock you for which you will be happy to trigger capital gains.
- No guarantee that stock won't resume upward climb after you sell, so be prepared not to look back on decision.
- If price continues to fall & reaches buy zone again, consider repurchasing (no wash sale to worry about if shares were sold at gain).

## If All Else Fails



- NAIC/BetterInvesting founder George Nicholson advised investors to allocate 5% of portfolio towards “**speculative**” opportunities.
- By ringfencing this portion of portfolio:
  - When picks work out, returns can be significant.
  - When picks don't work out, risk is limited.
- Speculative stocks carry high levels of uncertainty, so consider extending this concept to other “maybe” stocks in portfolio.



## Questions?

## Escaping from “Maybe Zone” Stocks

### “Sell” Is Four-Letter Word



- Let's strike “sell” from the vocabulary.
- Instead, think “**replace**” or “**upgrade**.”
  - Your portfolio can always be upgraded.
- Remove “maybe zone” stocks by replacing for higher-quality, higher-total return stocks.

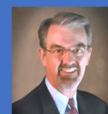


## Still Unsure? Shift Your Thinking



- If you are uncertain about whether or not to sell, mark underperformer “**Available for Cash**” (AFC).
- Then carry out search for replacement candidates.
- Tagging stock helps brain & club members to get accustomed to getting rid of it.
- Excitement around new stock pushes thoughts of prior holding into distant memory & reduces feelings of regret.

## When to Take Action



- Ask yourself why you are holding on to uncertainty:
- If truly unsure or because you are “hopeful” for better outcome, consider stock in question as “candidate for replacement” instead of selling outright.
- Then search for candidates.
  - Most compelling candidates will provide ample rationale to replace underperformers in portfolio.

## No Room for Intuition in Investing



- There's little room for your “gut feelings” in investing.
- Back up decisions with research.
- If facts don't fully support your investing thesis about stock, don't quickly jump to action.
- Add company to watch list & wait for more information to be revealed.
- If opportunity is lost, don't fret – there will always be more!

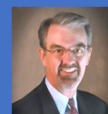
## Summary of Strategies for Coping with Uncertainty

## Strategies for Coping with "Maybe Zone" Stocks



- Build in **Margin of Safety** in each buy decision & construction of portfolio.
- Put "Maybe Zone" stocks "**On Probation**" & have defined plan for handling.
- Use TSLO on **Hypervalued** stocks to capture future upside but automatically sell on price declines.
- Move questionable stocks into "**Speculative**" portion of portfolio.
- Mark uncertain companies "**Available for Cash**" & seek replacements.

## Consider Using These 4 Portfolio Baskets



- **Hypervalued** - stocks in excessive valuation range with TSLOs set.
- **Available for Cash** - stocks that require replacing when candidates can be found.
- **On Probation** - companies not to be bought or sold until more information becomes available.
- **Speculative** - stocks that may carry some long-term potential return despite risks.



Questions?

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**Need Help with Stock Selection?**



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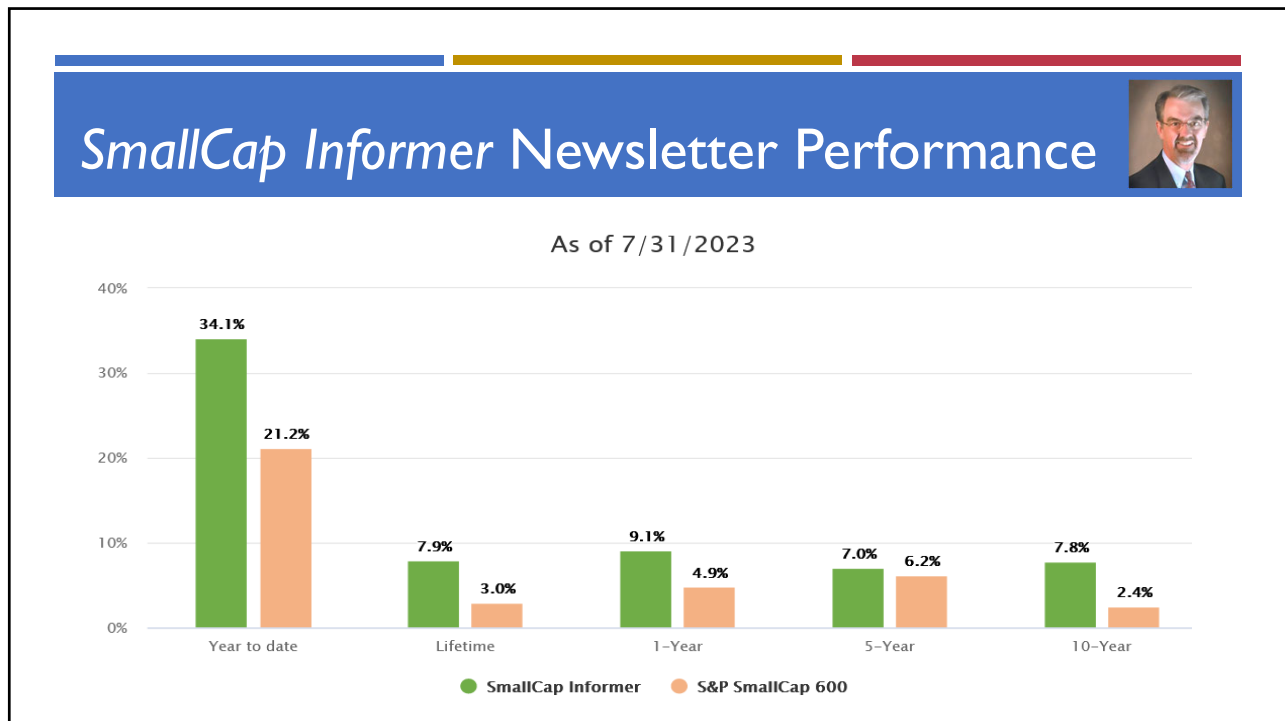
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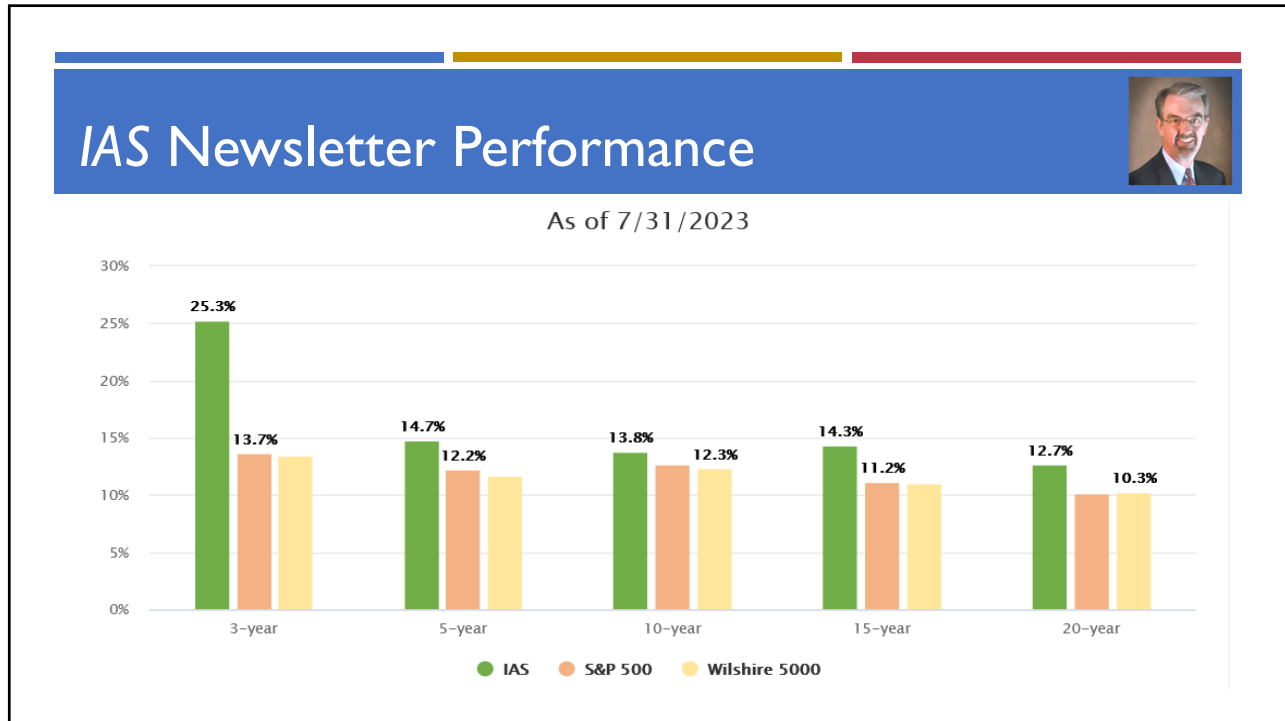
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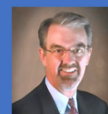
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