Wealth Management

The Crescent Group

RBC Wealth Management
The Crescent Group
Carsten Frederiksen, CFP®
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
Direct: 214-775-6401
The Crescent Group website

Paul Hendershot
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus

Nick Weege
Financial Advisor
214-775-6408

Lindsey Wood, MBA
Client Service Associate
214-775-6458

June 2018 Investment Commentary

In past commentaries, we've often spoken of how we love buying great companies when no one else wants them. In this month's commentary, we discuss the other side of the investment equation–selling a great company when everyone wants it and it becomes overvalued.

One of the hardest things for an investor to do is to buy a company facing a substantial but solvable problem. Usually when a company encounters such a problem, the news headlines make it seem like the sky is falling. The media and self-proclaimed "experts" behave as if the company is headed for bankruptcy and list the reasons why no one should own it. The stock price typically falls substantially and even crashes 30% or more in a lot of cases. It takes a great amount of research, independent thinking, and conviction to sail into the storm when everyone else is fleeing. And yet, how else can you buy a great company on sale, except under pessimistic circumstances like these?

Of course, before buying shares of such a stock, it's critical to do the necessary research in order to have a very high degree of conviction that a company's problem is indeed solvable. Over the years, we've bought great companies experiencing a variety of solvable problems: cyclical downturns (which were guaranteed to reverse at some point), supply chain disruptions (guaranteed to become undisrupted at some point), shifts in consumer purchases of the company's products from in-store to online, increased competition requiring improved marketing, advertising, and product innovation, and product contamination. In each of these cases, we asked ourselves if the long-term attractiveness of the brand was impaired, and in each case the answer was no.

At some point, each of those companies got past their problem. Each problem was unique, so it took a different amount of time for each one to get resolved. For the different companies facing problems that we've bought, the shortest time that a problem was resolved was a few months (this was a need for more advertising/marketing/product innovation), whereas some problems took several years to resolve, with the longest taking four years (this was a cyclical industry downturn).

The pattern that these problem scenarios follow has been the same in all cases: after the company encountered the significant but solvable problem, investors acted as if the problem would never go away. Our

Group would do our own research and determine that the problem was actually temporary and solvable, and that the current low stock price represented a very good value relative to the long-term earnings potential of the company. We would acknowledge the value and start buying shares at a time when no one else wanted the company. News headlines were terrible, and about half the time the stock price would fall further, presenting us with an even better value, and we would buy even more shares. Eventually the company would, as we expected, get past their problem, and their quarterly earnings results would be much better than analysts and investors expected. When this happened, the stock price would typically jump 10-20% or more in one day, and continue to move upward as investors and analysts came to realize that the problem had been solved and the company would now earn more than they thought going forward.

But just as investors typically become overly pessimistic when a company encounters a problem, they have a tendency to become overly optimistic when a company has done well recently. When this happens, a company's stock price can get pushed well above what the company is worth on the basis of its long-term earnings potential. When this happens, we sell. Why? Because as we just discussed, every company encounters a problem from time to time. Eventually, a company firing on all cylinders will encounter a problem and its stock price will fall. Or, if that doesn't happen, the stock price could simply not move up for years. We've seen case after case of great companies whose stock prices go nowhere for ten years. As far as our Group is concerned, buying a company for less than it's worth and selling it for more than it's worth is an investment home run. Legendary billionaire investor Carl Icahn put it best in an interview with the New York Times: "The real money that I made over the years is holding companies for seven, eight, nine years and keeping 'em...You gotta buy 'em when nobody wants them really. I mean, that's the real secret...It sounds very simple, but it's very hard to do. When everybody hates it, you buy 'em. And then when everybody wants 'em, you sell it to 'em."[(1)]

Some of you may be surprised to hear that even Warren Buffett, known for stating that his favorite holding period is "forever", has also publicly admitted that he should have sold his overvalued holdings: "Nevertheless, I can properly be criticized for merely clucking about nose-bleed valuations during the Bubble rather than acting on my views. Though I said at the time that certain of the stocks we held were priced ahead of themselves, I underestimated just how severe the overvaluation was. I talked when I should have walked."[(2)]

When a company has done well recently, it becomes difficult for investors to sell its stock for the exact opposite reasons of why investors have a hard time buying the stock of a company doing poorly. Typically, the stock price has surged recently and investors mistakenly project that performance for the long-term. The financial media and "experts" love the company and often cite the stock as one of their top picks. Selling a stock in this situation once again requires independent analysis and a willingness to act opposite to what everyone else is doing. Some investors will also add the tax burden as part of their reasoning for not wanting to sell a winning stock. But realizing long-term capital gains is actually one of the most tax-efficient forms of income available in the United States.

As we mentioned above, even the best of companies encounters a problem from time to time. We've seen some of the greatest and most admired companies in the world fall 30%, 40%, 50% and more when they encounter a temporary problem. It's better lock in a large gain and pay the capital gains tax than to watch that gain disappear when the company encounters a problem and the stock falls. We will continue to help our clients profit from our independent analysis by executing on our strategy of buy, hold, and, just as importantly, sell.

Best Regards,

The Crescent Group
Carsten Frederiksen, CFP® | Paul Hendershot | Nick Weege | Lindsey Wood, MBA

Sources:

(1) The New York Times
(2) 2004 Berkshire Hathaway Chairman's letter

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