Back to Basics: Sell Rules

Dave [00:00:03]:

All right, folks, welcome to Investing for Beginners podcast. Today we're going to go back to the basics. Today we're going to talk about some reasons why you would want to sell a stock. So if you are not new to our show, every Thursday we talk about a back to the basics episode. These are foundational ideas that we can use to help you become a better investor. So come back every Thursday if you want to become a better investor.

Dave [00:00:35]:

I guess. So with that, let's, let's start talking about why you would want to sell a stock. And so, Andrew, maybe you could talk about your first reason why you would want to sell a stock.

Andrew [00:00:50]:

Like myself. Rules?

Dave [00:00:52]:

Yes.

Andrew [00:00:54]:

Okay. Well, I have three cell rules, and they're pretty boring and straightforward. The third one's kind of less of a rule and more of a look for a red flag kind of an idea. I guess the first one would be, I like to sell negative earnings, and I've done that up to now. And then basically the idea is that before a company goes bankrupt, it generally will have a year or two or three of negative earnings. Sometimes it's happened as little as a year, but it can be two or three years. And so I've kept that sell rule and it's kept me out of trouble for stocks. Makes it hard because there are a lot of stocks that have negative earnings as a part of their business model.

Andrew [00:01:54]:

It's kind of part of the cycle, and I've tended to stay away from a lot of those. So in the future, I'm willing to potentially make an exception if this is something that's inherent in the business model. But up to now, I haven't made an exception, and I feel like it served me pretty well.

Dave [00:02:14]:

Yeah, I would say it served you pretty well. Like you said, it's kept you out of trouble.

Andrew [00:02:20]:

Yeah.

Dave [00:02:22]:

So I guess when you're thinking about that idea, is it something that is, if they have one quarter, you're out, or is it generally, is it a year?

Andrew [00:02:34]:

Yeah, I mean, I just set a year because it's pretty simple. I don't know. Lots of things can happen in the quarter, and you can argue a lot of things can happen in a year, too. I would say it's just less frequent on a year basis than it is a quarterly basis. And again, when I was looking at the bankruptcy research I did, I wasn't looking at quarterly numbers, I was looking at annual. So it's definitely a really, like, risk averse, like, really trying to protect your downside kind of take on all of that. But I did look at 30 of the biggest bankruptcies. This was, like, ten years ago, but 30 of the biggest bankruptcies in the 21st century.

Andrew [00:03:20]:

And the most common characteristic was negative earnings in the year before bankruptcy or more. So it's kind of like an easy. Okay, well, I'll just stay away from that.

Dave [00:03:32]:

Right. And in the investing world, we want all the easy buttons we can possibly find, right?

Andrew [00:03:38]:

If possible.

Dave [00:03:40]:

Yeah, if possible. One of the. I think that's a great rule. And like you said, it's easy. It's simple. And especially most of the companies that you focus on and buy, generally, it's. They're not. They're not flirting with the Mendoza line, if you will.

Dave [00:03:57]:

Like, they're not generally, you know, going negative a lot. And so when something like that does happen, that's probably a bigger sign of other things that could be potentially be wrong. And it's probably better to get out early than not in a certain circumstance like that, for sure.

Andrew [00:04:17]:

Yeah, I think so. What about you? Do you have something that you kind of go to as a first indication of us selling something?

Dave [00:04:27]:

For me, it's. I wish I had something simple like that. Mine is. Revolves more around if my thesis has changed, if something about my thesis was wrong, or if it's changed, then I will consider selling the company. And if it, you know, I try. I try really hard to write everything down so that I have a way to reference back what I was thinking when I bought a company. And sometimes in the heat of the moment, you've. You can forget that.

Dave [00:05:06]:

And so I find that's an easy. An easy crutch to go back to. Okay, I bought this company. This is why I bought this company. And if I'm seeing things I don't like, either it's because I made a mistake in my analysis, which happens, or there's something that's going on with the company that they've changed. Maybe management has changed. Maybe they have decided that they want to focus in a different direction, that I thought was really the direction they should go. That has happened many times as well.

Dave [00:05:36]:

And so those are. That's really the. It's not a. There's no numerical idea around it. It's more of a touchy feely idea than it is any hard, fast rule. So it really goes back to what I thought, why I bought this. You know, I bought Visa because of this. And now, all of a sudden, they've changed.

Dave [00:05:56]:

Direction, or I see that their moat is eroding, then that would make me want to sell the company. And if I can see that continuing to happen over a longer period of time, and you can see that in the numbers too, if you see the motor roading, you can see revenues secularly dropping over a long period of time, then that could be an indication that the moat is eroding or my thesis has changed and then it's time to get out.

Andrew [00:06:27]:

What would be a case of a company where the direction changed? Like, what does that look like?

Dave [00:06:36]:

Yeah, well, I think the easiest one, the most obvious one for me was GameStop. And when, and this was way before the meme thing. So don't confuse what I'm talking about with the meme period of GameStop. I'm talking about when it was still being considered an air, quote, real business. They used to be one of the more, I guess, the bigger players in the gaming industry as far as like selling console units and selling games, the actual games, and in the rise of streaming games and being able to download the games on your consoles, GameStop kind of started to become more obsolete. And one of the things that they were going to try to do was get bigger into recycling games as well as collectibles. And I thought that that was a great decision and I thought that could really offset what they were seeing, the drop in the other parts of their business. And as they kind of started to go down that path, they decided to change and go back to trying to be the console people.

Dave [00:07:45]:

And I thought that was a huge mistake. And the numbers never really got better. If anything, it got worse. And so I just decided to cut my losses and sell. I think I lost 60, 70% of my investment on the company. So it was not a, it was not a great, it was not a great choice.

Andrew [00:08:06]:

Yeah, that's a. I mean, that's a good example. Thanks for sharing it.

Dave [00:08:11]:

Yeah, you're welcome. I mean, it's painful, but, you know, hopefully somebody can learn from my, my mistake, my misstep. So what's rule number two?

Andrew [00:08:22]:

Rule number two is if they cut the dividend, and I've bought every stock I've recommended for value spotlight, with the exception of one stock has paid a dividend. And so, because that can be one of the first things to go when the company's in trouble. So just thinking about that statement when a company's in trouble. Okay, cool. They just told me, right? I don't have to like, think about it. They just told me, right. So again, just so simple that there's not much to be said about it, but it's just something I've kind of had. And again, like selling rules to keep me away from downside.

Dave [00:09:12]:

Right.

Andrew [00:09:13]:

Yeah.

Dave [00:09:14]:

So can you give us an example of a company that cut their dividend and then that was when part of the reason why you decided to get rid of it, Robert.

Andrew [00:09:23]:

Yeah, and I cant remember which came first, if it was the negative earnings or the dividend cut, but Disney, during the whole pandemic, they had their theme parks shut down. They, this is just really tough for them. And then it kind of compounded because a lot of that stuff obviously came back once the reopening happened, but it didnt help an already perilous situation. And then they had been facing pressure for years from cord cutting, because if you havent followed the company, they own ESPN and ABC and kind of those, you know, all those. So they're hit really bad by the Netflixes of the world and all the streaming platforms that have come and taken share out of the traditional media companies. And so they talked about cutting the dividend to really reinvest in Disney, and there's a lot of uncertainty there. And I'm not saying that they're going to be wrong with it, but, um, it's, I guess you could, you could argue that it's not the same investment I bought when I first bought it, because it used to be more of a cash flowing dividend payer, and now they're reinvesting in an uncertain growth venture and reinvesting pretty heavily. So, um.

Andrew [00:10:51]:

Yeah, I guess that would be an example.

Dave [00:10:54]:

Yeah, that's a good one. That's a really good one. Yeah, that was, that. I remember that time. That was kind of a double, double whammy for you with the negative earnings and the cutting the dividend. It's like, well, they're not, they're not giving me a lot of leeway here.

Andrew [00:11:09]:

Yeah.

Dave [00:11:10]:

So if a company, let's say, just for example, let's say that a company is paying $1.50 a year dividend and they reduce it to maybe $1.25, would that enter the cut rule? Or is it more like Disney went from a dividend to no dividend? Is that, is it like that kind of cut of a dividend?

Andrew [00:11:34]:

Yeah, that's a great question for me. It's if they completely stop paying one.

Dave [00:11:39]:

Okay.

Andrew [00:11:40]:

Cause I think it's a decent chance that signals, I mean, a lot of companies do reinstate a dividend after they get through a tough period but it can signal a change in the way they're gonna do capital allocation from here moving forward. And so if that doesn't fit my, what I'm trying to do with my portfolio, then it becomes easier for me to sell it.

Dave [00:12:02]:

Yeah, I think that's an easy rule. And to your point, it really could indicate something further distressing about what's going on with the company, because they don't take those decisions lightly to stop paying a dividend because they know that the market reaction is going to be pretty severe. And they also, likewise, when they start a dividend, they don't take it lightly either, because they know if they stop, it's going to be, you know, stock market is going to beat it up pretty, pretty severely if they stop. So, yeah, for sure, that's a really good rule. I guess the next one on my list, if you will, would be if something fundamentally changes about the business. And so it's a little, again, it's a little, a little abstract, and there's, there's not a hard and fast way to determine what that is. But if a company is going one direction in a business and all of a sudden that business ceases, or they're trying to pivot into something else and it's not a successful pivot,

then that can be a, that could be a really hard place to be as an investor for when a company tries to do that. And we've talked a lot of times about intel, and that is one of the things that they've been trying to, they're trying to make a pivot now, and it's not going well at all.

Dave [00:13:34]:

And so it kind of goes back to what Warren said. You know, turnarounds are really hard. Turnarounds often don't often turn. And so I guess I've interpreted that as if a company is operating one way and then they decide to change the direction that they're going, and that's not a profitable good way for them to go, then I'm going to be out. So a good example would be Microsoft. If they had, when Satya Nadella took over and he started switching them more to the cloud and getting into the subscription business for office, the office suite of products that they have. If that hadn't been successful, then that would not be a great investment. And they were not, they were not headed down a great path to begin with.

Dave [00:14:18]:

So he really did rescue them in more ways than one. But it, if he had decided to change directions and that hadn't gone well, that would have been a really tough, tough thing. I have not invested in block or square, in large part because they have never really decided on a vision or a path. They had one when they first started. You know, the little dongle that they created that allowed really small businesses to, to accept payments was a brilliant thing. I saw it firsthand when I was at the bank because they had all these, all these people coming in, wanting to start driving and using that in their iPhone to take payments for customers. And I thought it was a brilliant, brilliant idea. But then they kind of veered off into doing business banking, and now they're into the bitcoin thing.

Dave [00:15:05]:

And that just, I was out. I just, I was, I was interested for sure. But once I started discovering, you know, they can't really decide on a path. And it seems like every other, every other quarter, they're announcing a new direction for the company. And that, just, to me, that's, that if I was, if I owned the company, I'd be, no, I'm done here.

Andrew [00:15:26]:

Yeah, yeah, me too. That's a, that's an interesting one, for sure.

Dave [00:15:33]:

It has so much potential, but it just seems that they can't really decide on a path and they just hit it and go for it, kind of.

Andrew [00:15:41]:

Yeah, I guess. You don't know how long that misdirection, lack of direction, however you want to phrase it, could go for, right? I mean, the value investor, me, says, oh, well, that, that could be opportunity, because when they do figure it out, right. Hey, like you said, it's great potential. I mean, the, the square dongle itself is probably one of the great branding decisions that company has made. But the question becomes, like, well, how long do you have to wait for that to turn? And is it going to?

Dave [00:16:14]:

Yeah, I think another great, great example of that is I'm not sure if it's been avoided or if it's just been kind of overshadowed by more recent success is meta. We were talking last episode about how they have a moat, but one of the things that, that Zuckerberg was doing a few years ago that it was getting bashed for was that the whole reality, labs in the metaverse and the billions that they're still investing in, creating that, and that could derail the company. And they, you know, last year was the year of, what was it? The year of efficiency. And so they, they got their profits back up and revenues were growing again. And so I think that's kind of overshadowed the, the investment in reality labs, but it's still there, and he's still pumping a lot of money. Into it. And if that becomes a bigger and bigger part of their capital allocation, that could derail the company at some point. And so if I was an owner of meta, I probably would bail, because if it became a bigger and bigger part of their reinvestment strategy, I'd be, eh, I don't see that happening.

Dave [00:17:23]:

I'm out.

Andrew [00:17:24]:

So do you feel like the capital allocation can play a pretty big role in this whole conversation?

Dave [00:17:32]:

Absolutely. Yeah, absolutely. 100%. Because that's the CEO's job. Number one is what to do with the money we make. And if the company makes any money, they got to figure out what they want to do with it. And that's what sets Warren Buffett apart from every other CEO that runs a company, is he allocates the capital so well. And whether he does or does not do things is it's an allocation decision, and he does it as well as anybody, and that's what makes their company successful.

Dave [00:18:08]:

It's what made Amazon so successful was Jeff Bezos was not only willing to take chances, but he was also really good at, you know, spending. When he found something that worked, he. He put money behind it to make it as successful as it possibly could. All you gotta do is look at AWS or prime or, you know, a myriad of other things. So that's what set him apart from other, other companies. Well, that. That, to me, if you see that going the other way, would be. Those are good examples.

Dave [00:18:39]:

If you see poor examples, though, those would be examples of, you know, if you see Roic going the wrong way, or if you see that the company is spending more than the cost of the capital that it costs for them to reinvest, then they're destroying value. And that's not where you want to be either. And if you see that on a consistent basis, I'm not talking about one year, but if you're seeing that three, four, five years, then that's a problem, because now they're destroying value for the business, and that means it's time to go.

Andrew [00:19:08]:

Yeah, you had a great tweet the other day about the Warren Buffett way. And so it compelled me to open up my copy and, like, just kind of flip around. And there was a quote in there. I pretty sure it was from buffet, could have been from Charlie. But he's basically saying that, like, if a business. What was it? It's like, if a business only grows at what it puts in, then basically the idea of, like, you're getting low returns on your investment, and it's not above the cost of capital. But if a business is only earning what it's putting in and it's not earning a return on it, it'll still show growth and earnings still show growth in revenue. But it's the exact same compounding as if you put money in a savings account and earned interest on that.

Andrew [00:20:02]:

And so you want to look for the businesses that drive excess returns and not just growth that's not profitable because it's just a big waste of money.

Dave [00:20:14]:

Yeah, yeah, that's exactly right. I think that's a great way to think about how they allocate the money that they generate and what kinds of returns that's generating for the company. And if you look at the long term performance of the CEO who's running that particular company, you'll see patterns. And I think if you aren't seeing, if you aren't seeing growing patterns in the capital allocation and the returns that they can generate, then that to me indicates either there's something systematically or structurally wrong with the company,

or that the CEO and the board or the other managers are just making poor decisions on what to spend the money on. To me would be an indication, you know, if I didn't notice it when I got in and I was, I did own the company, then that would probably be something that would drive me out.

Andrew [00:21:07]:

Yep. Is there like a period of time you look for, for something that looks like maybe bad capital allocation?

Dave [00:21:18]:

I probably try to give it, you know, three to five years of, of returns to see what that is. I think a year is too short and a couple years is probably too short. So three years is probably the minimum. But anything longer than that, if I own the company, its probably going to be three years, truthfully. But if Im trying to decide whether I want to invest in the company, Im going to look at five or ten year period to see where, you know, what kind of history they have of allocating capital, particularly if the CEO in place is the same person making those decisions during that period of time, then that helps kind of make, that helps make a judgment on, okay, if they've done this in the past, history tells me that they probably are more likely to do it again in the future. So what is rule number three for you?

Andrew [00:22:16]:

So this is the rule that has served me really, really poorly. And I just tweeted actually maybe a week or two ago that this contributed to my number one mistake as an investor. So the rule itself, not much wrong with it. Basically, if a company piles up too much debt, then that's a red flag. But I never set a rule like, oh, if they double their debt, then I'm gone. Nothing like that. But you just have to be careful because you can take me, particularly being guilty of this, you can take some of these number metric kind of ideas and take them too far and can really hurt you. So when I had a company called Lamb Research, they were like a debt free company.

Andrew [00:23:18]:

Either it was debt free or very low debt, and then they had a period of time where they were reinvesting in the business and it became a lot more leveraged than it used to be. But it wasn't like a crazy amount of leverage, it was just more than it used to be. So that combined with my scarcity mindset of really wanting to lock in these gains contributed to me selling the stock. And since ive sold it, I cant remember and I dont want to go back because it hurts to check, but either theyve gone up 300 or 400% since I sold, and theres something painful about being right about a stock and, and then selling for a stupid reason and then seeing your thesis play out correctly and you don't get to participate. So, um, that's maybe a cautionary tale with

any metric based thing. If you are too slave to the metric and the numbers and you don't put any intuition into it, um, it can really lead you astray. So you do have to be careful.

Dave [00:24:27]:

Yeah, yeah, that's for sure. Yeah, that was kind of back in the time when we felt like all debt was bad and. Yeah, I think we, I think we've learned that there's shades of gray since then.

Andrew [00:24:42]:

There's just, yeah, prudent ways to do debt and non prudent ways. Yeah, I mean, in the past, you know, back in the old days when interest rates are really high, a lot of the best companies did have a lot of lower debt. As interest rates got really low, debt became a lot more acceptable. And it made sense because your interest.

Dave [00:25:05]:

Expense isn't that high, it's a lot cheaper.

Andrew [00:25:09]:

Yeah, but it's one of those mistakes hopefully people can learn from.

Dave [00:25:14]:

So how do you try to treat that now?

Andrew [00:25:21]:

That's. Man, I gotta think about that for a second. Well, I'm definitely looking, looking more towards kind of your idea around. Has, is there something fundamentally wrong with the business? And that's more important than is a metric going this way or that way? And so the metrics can be really helpful in helping you see when things are going the wrong way. But to only focus on the metrics will lead to more mistakes. Like this. So I'm also, I think, learning that my preferences on the stock to have some leeway on some really great businesses, and because businesses do stumble and they do struggle sometimes and, and you do have to sit through some painful periods. So that all said, that's kind of how I'm trying to think of.

Andrew [00:26:45]:

Think of it moving forward.

Dave [00:26:50]:

Yeah, that makes sense. I like that. I mean, I think when you're thinking about numbers and how they impact our decisions, there's obvious red flag numbers where the debt could get out of hand, where they can't afford, like they're taking on too much and they can't afford the interest payments, or it's going to be really, really tight. If you have a, they have a bad period, it could be really hard for them. That's one way. If you see revenues going the wrong way for a long period of time, if you see margins going the wrong way for a long period of time, I think those are all, to me, all obvious red flags or things that could tell you, like, to your point, negative earnings. If you see that for one year or longer, and the company's never experienced that, that or has been, you know, 2030 year period since they've experienced that, that, that is, to me, would be a very strong indication that there's something wrong going on with the company. I guess the thing about selling, and we haven't mentioned this yet, but something I came across on Twitter not too long ago, which I thought was kind of brilliant, was, was to buy slow and sell even slower.

Dave [00:28:01]:

And that idea of just taking your time selling the company, and I think a lot of us, myself included, can be too knee jerk reactionary to bad news in the markets. And sometimes we need to sit on things and let it simmer a little bit to think about what our decision is going to be and why we're going to sell it. And I think to me, that's where having some sell rules in place and using a journal of some variety to write down why you made a decision you did, I think, can be really, really helpful, especially in times of turmoil when your company you own drops 2030, 50% in a day or two. That's quite the roller coaster emotionally. And I think having those kinds of tripwires, if you will, in place to help keep you making an emotional decision can be really, really helpful. And that's why I think that idea of buying slow and selling even slower is something that I've kind of, kind of become a little bit of a mantra for me. And it really helps me avoid being emotional when I think about whether I want to sell a company or not.

Andrew [00:29:15]:

Yeah, I love that idea. I mean, we had. I feel stupid saying this, but we had, like, a YouTube short that was kind of around that idea of, you don't need to sell very quickly. You can take time to digest it. And it got a bunch of down votes. And I was like, huh, that's interesting. And then I thought about it. Your strategy kind of can dictate whether you have the luxury to do that or not.

Andrew [00:29:44]:

So in the way that Dave and I have chosen to invest in companies for the long term, and we've done the work to look for companies that can last for the long term, that gives us the luxury to sit on decisions,

because those kinds of things don't turn overnight. And so because we've decided to partner with businesses that are long term focused, have long term results, and have these moats and all of these things, we're able to sit on those and sell slow, and it works really well with our strategy, I think.

Dave [00:30:22]:

I agree. Agree. Anything else you'd like to add? Okay. All right. I think that was a good place, then. All right, I'll go ahead and count us up. I got a one and a two and a three. All right, folks, well, with that, we will go ahead and wrap up our conversation today on cell rules.

Dave [00:30:43]:

Hopefully, you found some value in that. And I think considering having some sort of cell rules and a journal of why you bought the company can be very, very helpful. And so I would strongly encourage you to consider, you don't have to adopt our rules. You can find other ones online. There's lots of great opportunities to find stuff out there with Warren, Charlie, Phil Fisher, and others, and they could be very helpful. But I hope you guys enjoyed that. And with that, we will go ahead and sign us off. You guys go out there and invest with a margin of safety.

Dave [00:31:10]:

Emphasis on the safety. Have a great week, and we'll talk to you all next week. Ow. Owen.

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