FUNDS ON FRIDAY
by Glacier Research

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17 September 2021
Volume 1110

When should you give up on a share?

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Admitting defeat on a share is psychologically difficult. It helps to have a process for review and sale when your original thesis changes.

The disposition effect relates to the tendency of investors to sell assets that have increased in value, while keeping assets that have dropped in value. Hersh Shefrin and Meir Statman identified and named the effect in their 1985 paper[1], which found that people dislike losing significantly more than they enjoy winning. Humorously, they called it '*disposition*' as shorthand for "*the predisposition toward get-evenitis*".

The disposition effect is one of the many biases that investors must face – and overcome – when managing long-term focused investment portfolios. It is one of the most difficult ones because it forces the investor to confront the most basic of emotions: pride, while simultaneously combatting our built-in reluctance to embrace loss.

Know what you own, and know why you own it

Early in my investment career, a colleague told me to write down the reasons why you buy a share, and why you sell it. Writing down the reasons why you buy a share forces you to revisit your assumptions when the share price rises or falls.

I continue to do this to this day. Keeping records of your original investment case is a small disciplinary exercise with significant positive implications for your investment portfolio. For many investors, it can be the crucial reminder of when to let go of a losing position.

A typical trading approach looks something like the following. You take a number of active positions, sizing them based on the risk and return you expect from each stock. Poorly defined limits mean you probably end up with more allocated to risky shares, because you estimated the profit opportunity to be higher. Some trades work out and can be sold at a profit. But for many investors, it is too difficult to take a loss, and they hold on to losing positions hoping that those losing stocks will eventually turn around.

Incorrect sizing and hanging on to losers long past the time when you should have cut your losses, mean the average investor loses money on the stock market, or at best the winning stocks compensate only slightly more than the losses from the losers.

It's tough to do, but the best advice on buying and selling is often to ask yourself, 'do I hold this share because I'm influenced by the losses that I wanted to recoup?'

Process triumphs over disposition

Good investors fight the disposition effect by following a process that provides a framework for buying and selling. Following a process allows them to combat human frailty – and pride is one of the biggest frailties in investments. Without a disciplined process there can be no significant long-term outperformance.

In some cases, the protection from disposition goes further. Not only should good investors not hang on to losers, but they should spend much time evaluating the different outcomes in investment cases – and know them so well that they can also opportunely add to positions when they fall.

Many asset managers, us included, follow this practice. The example I often use is imagining for a moment that your house suddenly fell in value by 20% in the course of a week. Would you sell it? Probably not. There is very little that would derail the value of a property to such an extent over such a short period of time. In fact, you probably know your neighbourhood well enough to say that price fall was irrational: the neighbourhood is still attractive, near the school, spacious and close to a national park for example, and none of this is reflecting in the price. You should actually be buying more houses in the neighbourhood.

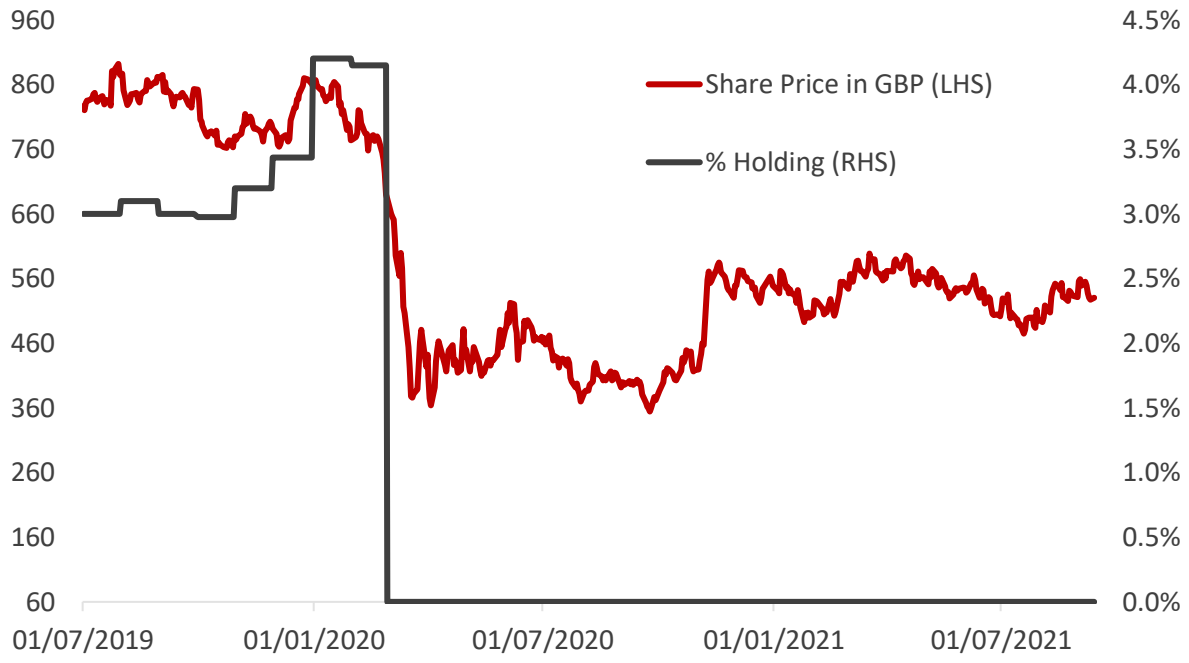
Sell when your original thesis fails – don't construct a new one

Recreating the narrative once a stock goes against you, is an understandable response to a failing investment case. It's human. Pride often prevents even good investors from capitulating on a share.

We've found that the answer is to follow a process or built-in procedure for review and sale when your original investment case (the reasons you bought the share) are shown to be incorrect. The benefits of having a process are instructive here, which I can illustrate with two examples from our global stock selection in the past two years.

The first is Informa. Informa is a powerful marketing, business intelligence and in-person events platform business. The investment thesis consisted of growing its various revenue streams in excess of peers while increasing profitability, and in so doing garnering a higher multiple to earnings than its long-term average.

Chart 1: Informa Plc share price versus holding % in the Flagship Global Funds



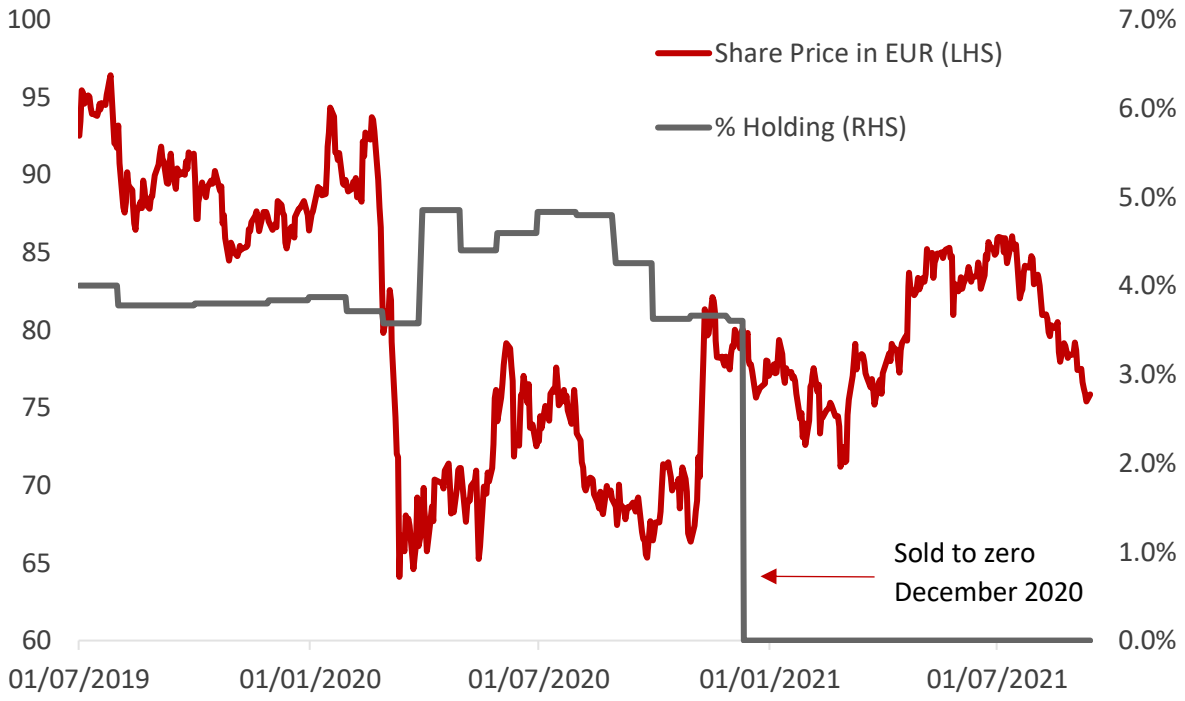
As of February 2020, trade fairs and exhibitions generated almost two-thirds of Informa's operating profit. As the COVID-19 outbreak began to gather pace, Informa revealed that an increasing number of its shows were being postponed or cancelled. Its flagship health & nutrition show in the US – as well as a number of its important Chinese and Japanese trade fairs – were put on indefinite hold. We calculated that EPS could fall a material 30% in 2020, and between 40-50% in a bear case scenario, with little visibility thereafter.

Our original thesis no longer held. Rather than attempting to construct a new thesis (which in this case would be a recovery play – an entirely different investment case) we sold the share at c.600 GBp.

Heineken is another example of selling when the initial investment case changed. Heineken is a high-quality consumer staple stock, which we bought to participate in the growth of beer volumes in emerging markets (particularly Vietnam, Mexico and Africa), as well as the steady increase in operating margins from the mid-teens to 20% longer term. This is a powerful algorithm which is not unfamiliar to long-term investors.

The pandemic changed this. Initially we expected the effects of global lockdowns to be short term in nature, with minimal impact on Heineken's long-term volumes (and investment case). As the pandemic deepened and movement and celebrations across key markets were curtailed, the investment case changed. Currencies in key emerging markets dipped, and raw material costs saw massive inflation. Employees were laid off and new debt was taken on. By December 2020, we took the call that the facts on the ground were too far removed from our initial investment case.

Chart 2: Heineken Holding share price versus holding % in the Flagship Global Funds



Conclusion

Long term investors are often guilty of assuming critical impacts to their stock's investment case is simply 'short term noise'. Often, this is a catchall for an investment case that has gone badly. The reluctance to embrace loss prevents many of us from admitting this to ourselves and making the right call, which is to sell. John Keynes' famous quote is useful here: When the facts change, I change my mind. What do you do, sir?

Glacier Research would like to thank Pieter Hundersmarck for his contribution to this week's Funds on Friday.

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Pieter Hundersmarck is the global portfolio manager for Flagship Asset Management, a specialist global investment management boutique based in Cape Town, South Africa. Pieter has been investing internationally for over 14 years. Prior to Flagship, he worked at Coronation Fund Managers for 10 years, and also co-managed a global equities boutique at Old Mutual Investment Group. Pieter holds a BCom (Economics) from Stellenbosch University and an MSc Finance from Nyenrode Universiteit in the Netherlands.

[1] SHEFRIN, H. and M. STATMAN, 1985. The disposition to sell winners too early and ride losers too long: Theory and evidence. Journal of Finance.