



## Cottonfield – Market Update: When to sell?

April 2006

### *Question:*

*Taking profits and thereafter reentering the same stock at a lower price is interesting only if the re-entry point is significantly lower.*

### *Answer:*

*At a critical time of assessing the wave's turning downwards, it is still better to take the profit and avoid the impairment of unrealized profits, subject to finding new investment opportunities;*

This was a question and an answer submitted to us by one of our clients.

Following, we present the Cottonfield view:

In our view the attitudes of both investors are plausible.

Investing is a matter of having information and being correct about the right timing (assuming that profit optimization and loss minimization as an objective is a given). Investor behavior seems to show, that stocks are bought after they have appreciated already considerably and that they are sold before their price peaks. While statistically and from a performance point of view it is very important to get in at very low price, this may be less of an issue as long as a stock continues to appreciate. For the average investor it is more important to define the right time to sell again.

Cottonfield's main principles are: 1) To avoid losses or to take them early. 2) There are always new opportunities. If it turns out that we sold a stock too early, we either look for new opportunities to invest money or we may reinvest in the same stock again. If we sell e.g. stock "A" today and at some point later we come to the conclusion that even at a higher level than what we sold A for is worth a buy, we should consider to buy it again without reference to the past but rather based on the potential (compared to other opportunities). Not having owned stock A in the meantime may have fulfilled a purpose such as the elimination of a (perceived) risk.

Investor A who does not take profits may encounter the following scenarios: The stock falls to whatever level and takes (a long) time to recover to the old high ... OR ... the stock moves further up and eventually the investor decides to sell at an even larger profit. But given that investors rarely manage to get the highest selling price the potential profit is hardly ever maximized, anyway.

On the other hand, Investor B prefers to take profits with the risk that he sells too early. If the stock sold then falls below the selling price, Investor B has the choice to buy the same stock again due to its potential ... OR... may decide not to buy it again but rather pursue an investment with more potential. Irregardless of whether the stock sold stays above or falls to or below the original purchase price, based on the latest information available, the investor has created an OPTION to reinvest into the same stock OR into some alternative.

In an up-scenario, Investor A may gain more, but in a down scenario Investor B has realized profits AND as a result of the latest information available to him / her has created new

investment options (while Investor A awaits patiently for a price recovery to take him to or above the level where B sold). If Investor B decides to reinvest into the same stock at a higher level than originally purchased, obviously he has "lost" some money. However, paying this "risk" premium may have been worthwhile given that it gave him a piece of mind in the meantime.

This said, we assume that our Investor B is not attempting to trade a stock but only to pursue a cautious investment approach. A trader's approach is to sell at the right time and buy the same stock again and again at the right time. Experience shows, however, that most investors trying to trade sell at the wrong time, meaning while the upswing is still intact. As the stock continues to appreciate, out of frustration they buy it again at a higher price than they sold, and probably get taken out again in the next correction. Instead of winning, they lose.

It all comes down to personal preference and the assessment of risk and opportunity. Investor B may be more risk averse and may leave some potential profits on the table. At the same time, he is creating an opportunity for himself to decide between 2 or more new investments with potential. Moreover, he may sleep better for the time being. And in the end, only time will show ... who the winner is.

To raise and address the opening question to this Market Update gives an investor an opportunity to reflect on his investment preferences. In our view, an investment style is closely related to the personality of the investor. What we do not know is to what extent investor personality and investment style have to be coherent in order to be a successful investor. This said, we feel that in any case it is worthwhile to reflect on our personal preferences as to investing and making investment decisions.

Given that Cottonfield does not depend on our clients being "fully" invested or not – unlike banks whose revenues depend on their clients' holding largest securities portfolios – we can assess the investment environment more neutrally. In today's market environment, there is a great deal of uncertainty: Earnings slowdown, oil and energy shortage and disruptions, housing bubbles, wars and terrorist attacks, mountains of debt, bird flu, currency upheaval, etc. Overall, it seems to us from a top view that the general upside potential for stocks is less pronounced than the risk of a downside correction. As investment advisor or manager, we fulfill a fiduciary role towards our clients. As such, we must rather live up to Investor B than Investor A type. We therefore may take profits earlier, or we may suggest holding larger cash balances at times and for some time ... until we see new windows of opportunity and where the investment climate is taking us.

As part of this "Investor B" attitude, and assuming that a general market correction may affect all values, we are most interested in identifying investment opportunities, that are less exposed to such correction than the average investment, and moreover, that recover faster than the average other investments. Interestingly enough, we believe that the investment opportunities we have identified for a worst case scenario bear at the same time the best potential were there no or only a minor correction to take place.

We hope that this Market Update supports you in better defining your investment preferences in challenging times.

Roy Darphin, Partner

Specific investment advice and -recommendations is reserved for our clients. Cottonfield Family Office AG is an asset management company and member of the AQUILA Investment AG. Among our clients we count Swiss and international high net worth individuals as well as institutional clients. We are located in Zurich, Switzerland.