A No-Nonsense Sell Discipline

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Behan: Can you talk about your sell discipline?

Nelson: Sell discipline is critical, really, in any investment approach. We consider our sell discipline to be one of our biggest competitive advantages.

Essentially, it's the opposite of what I just described that triggers our sell discipline or sell event. If we're sensing fundamental fatigue—in other words, the sustainable growth profile is showing signs of maturing or there's evidence that the underestimated growth that we were seeking, that caused us to have exposure to an investment, is showing fatigue. If we're no longer sensing there's as much momentum to the business, if they're showing less and less upside to the actual estimates or if, from the financial statements, it looks as if they're reaching to perform at the same level that they had previously performed at, we can look at various lead indicators that can trigger us to sell a security.

We have a very no-nonsense approach when it comes to looking at stocks in our portfolio and triggering sell events. There are a lot of stocks to choose from. The philosophy is why do we want to waste our time holding dead weight in a portfolio for the clients and mutual fund investors? If there's evidence of fundamental fatigue, it's time to reduce exposure. How much we reduce is going to vary situation by situation, but our mindset is to act quickly.

See, what tends to happen is that when we own a stock and it's in "beat-and-raise" mode and they're executing well, the valuation tends to expand. Let's say the P/E ratio on a stock went from 20 times to 45 times over the course of six or seven quarters while they were beating and raising and then things start to change and some of the metrics start showing fatigue. When you're at this elevated valuation and you sense that fatigue, it's important to act quickly because that valuation expansion you enjoyed when the company was executing well is vulnerable to compressing again. If you're going to traffic in higher expectation stocks, it's important that you've got one foot out the door at all times and you're watching these closely and carefully looking at those lead indicators. If you sense fatigue, you need to act quickly because there's vulnerability there—and that's exactly what we do.

I'm talking a lot about how great our sell discipline is, but we've actually put numbers to this. We've studied stocks that we've actually sold from the portfolio, and it turns out that those stocks persisted as losers after we sold them from the portfolio, on average. It adds credibility to what I'm saying about our sell discipline being so value-added. We can point to history and it's not a forecast. It's what's actually happened, so it's very compelling and it's resonated well with investors that we've talked to.

Behan: **Well, it seems that trading costs are very low compared to losing capital. So, how do you try and minimize taxes in that scenario?**

Nelson: I think that's a myth that's out there; the myth being: above-average turnover is an automatic for tax inefficiency. To the contrary, we buy and hold stocks for long periods of time. We like to let our winners run, so we're deferring gains for long periods of time. When we get losing situations, we're acting quickly and we're realizing those losses quickly. That in and of itself is very tax-efficient—not tax-inefficient, which is, I think, the myth part.

If you look historically at our mutual fund, we have shown a very strong tendency for tax efficiency. You're right, trading costs are low. That has helped enable us to have above-average turnover. It's not extremely high, but it's above-average. But importantly, it's very value-added, as I pointed out. Those stocks persist as losers after we sell them, and it's nice that we can sell those stocks at a fairly low cost. Trading commissions continued to drop over the last several years, and that makes it more beneficial to us to have that approach.

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