




Buy, Wait, Hold, Sell, or Avoid?

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Identifying Five Levels of Stock Valuation

STOCKS IN THE "MAYBE" ZONE: KNOW WHEN TO SELL, AVOID, BUY

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In This Session




- Strategies for handling "maybe zone" stocks.
- Understanding uncertainty when making stock decisions.
- Making better decisions when stocks are "on the cusp."
- 5 categories of valuation to help identify areas of risk.
- Portfolio "baskets" into which uncertain holdings can be sorted.

What Is the “Maybe” Zone?


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Buy, Sell, or Hold in Your Portfolio?




- Investment decisions seem clear-cut with 3 options:
 - Buy:** stocks you believe have satisfactory future upside potential.
 - Sell:** stocks you believe have significant chances of declining.
 - Hold:** stocks you believe are worth holding for potential upsides & have low chances of significant declines.

To Buy or Not to Buy



- When researching & reaching conclusion on potential new portfolio holding, you either:
 - Buy now.** Price looks good & fundamentals are strong.
 - Don't buy now.** Price looks high and/or fundamentals are “iffy.”
- But there is also a 3rd choice:
 - Stocks that aren't buys now **might** be buys if price or fundamentals improve... **MAYBE.**

Maybe Zone on “Original” SSG



4 EVALUATING RISK and REWARD over the next 5 years
assuming one recession and one business boom every 5 years, calculations are made of how high and how low

A HIGH PRICE – NEXT 5 YEARS
 Avg. High P/E (007 or 061) X Estimate High Earnings/Share (4C2) Lower 1/3 = (4B1) to (Buy)

B LOW PRICE – NEXT 5 YEARS
 (a) Avg. Low P/E (007 or 061) X Estimated Low Earnings/Share (4C3) Middle 1/3 = (Maybe)

(b) Avg. Low Price of Last 5 Years = (087) (4C4) Upper 1/3 = (4A1) (Sell)

(c) Recent Severe Market Low Price = (087)

(d) Price Dividend Will Support Present Divid. = _____ High Yield (01) = _____ = \$ _____ (4B1)
 Selected Estimate Low Price _____

C ZONING
 (A1) High Forecast Price Minus (4B1) Low Forecast Price Equals (01) Range, 1/2 of Range = (4C5)

(4C2) Lower 1/3 = (4B1) to _____
 (4C3) Middle 1/3 = _____ to _____ (Maybe)
 (4C4) Upper 1/3 = _____ to _____

Present Market Price of _____ is in the (4C5) Range

NOTE: SSG Plus now calls **MAYBE** zone “HOLD” zone.

Five Levels of Valuation, by Doug Gerlach

“MAYBE” Is Not Same as “HOLD”



- Original “MAYBE” zone suggests each investor perceives different attributes that impact decisions, such as:
 - Different judgment applied about future prospects.
 - Whether stock held in taxed or tax-advantaged account.
 - Whether gains/losses if sold would be short- or long-term.
 - Understanding of external issues affecting company.
 - Impact of sale on portfolio diversification.
 - General uncertainty about company or stock valuation.

Stock Investing Decision Trade-offs



- “MAYBE” zone also reflects multitude of factors that come into play in all stock decisions.
 - We strive to find opportunities driven by **tailwinds despite** evident **headwinds**.
 - Huge warning sign: When **everything** looks good -- sure indication that something was missed or analysis is overly optimistic.
- SSG is “Aid to judgment, not replacement for it.”

Getting Stuck in Maybe Zone



- Confidence leads to action—but uncertainty (“maybe”) causes inaction.
- Paralysis driven by uncertainty is detrimental to performance:
 - We hold underperformers too long, worsening returns.
 - OR we hold outperformers too long, worsening returns.
 - OR we don’t buy when we should, missing opportunities to improve returns.

Always Acknowledge Uncertainty



- Uncertainty is inherent in stock analysis & investing.
- Investors must accept that they are seldom 100% “certain” about any investing decision.
- Always acknowledge that investing decisions are based on weighing both positives **AND** negatives.
- So how uncertainty be resolved about stocks in **MAYBE** zone?

How to Escape from “Maybe Zone”

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Better Methods Bring Better Decisions

- According to BetterInvesting (BI), long-term stock investing success with Stock Selection Guide (SSG) comes from 2 things:
 1. Find good companies.
 2. Buy them at great prices (i.e., at good values).
- BI approach to identifying “great prices/good values” begins with understanding P/E ratios & their trends.

Review: What Is a Great Price?

- SSG uses **Price/Earnings (P/E) Ratio** as key valuation measure.
- General rules of thumb:
 - If P/E is around average, stock may be **fairly valued**.
 - If P/E is lower than average, stock may be **undervalued**.
 - If P/E is higher than average, stock may be **overvalued**.
 - Reminder: Potential total return is calculated using estimated future highest P/E at which stock is reasonably expected to sell.
- Can these rules be refined a bit further?

P/E Ratios Measure Stock’s Popularity

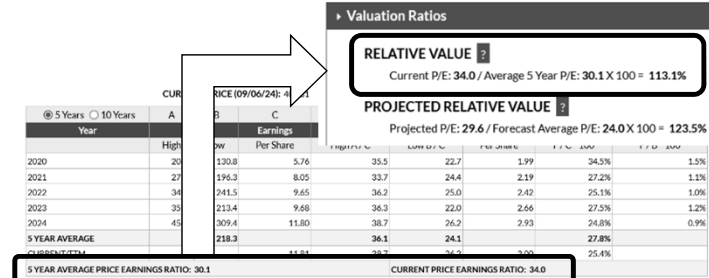
- P/Es measure of **popularity & investor expectations** about company’s future performance.
 - Companies like Nvidia, Apple, Microsoft have *higher than average* P/E ratios now because **interest** is high.
 - Companies in housing & RV industries have *lower than average* P/E ratios now because of **expectations** that economy may linger at lower levels.
 - Company with problems may see EPS decline & yet have *higher than average* PEs because of **expectations** that problems are temporary & will be resolved.
- P/Es can only be interpreted on **relative** (not absolute) basis.

Measuring “Value” with Relative Value



- Relative Value (RV) describes relationship of current P/E to past P/Es.
 - $RV = (Curr\ P/E \div Avg\ P/E) * 100$
- On SSG, RV around 100% says “current price is around average levels of past relative to earnings.”
 - RV < 100% says stock is under-valued, selling at **discount**.
 - RV > 100% says stock is over-valued, selling at **premium**.
- Usual recommendation: Buy if stock is selling near or below 100% RV.

RV on SSG Plus (in Ratios Tab)



Monitoring Value with Projected Relative Value




- Once stock is owned, use **Projected RV** to quickly assess value.
 - $Projected\ R/V = (Proj\ P/E \div Proj\ Avg\ P/E) * 100$.
Where Proj Avg P/E is average of user-chosen future high & low P/Es.
- Why use Projected RV?**
 - Accounts for expected **future contraction or expansion of P/Es** compared to past, according to your SSG judgment.

RV in Portfolio Management



- PERT (Portfolio Review) Report flags stocks when Projected RV is at either excessive end of ranges:
 - Proj RV is <80% — stock is in “**warning**” territory.
 - Proj RV is >150% — stock is in “**overvalued**” territory.
- Seems straightforward, but...

Highlighting on PERT Report




BETTERINVESTING

Report Details


Any I.C.

Company Name	Div %	Yield	Est EPS	EPS	Sales		Pre-Tax Profit		TTM EPS	Price	Proj EV	Proj RV			Est EPS	PEG Ratio	LTD Ratio	% Total Return			
					Qtr	Mo	Qtr	Mo				Qtr	Mo	Qtr					Mo	Hi	Avg
Walmart	0.83	1.1	07/24	0.56	-42.4%	169935.0	4.8%	6213.0	-43.1%	3.7%	1.92	11.0%	37.6	138.4	31.0	27.2	23.3	6.0	6.3	6.1	2.6
Office's Bargain Out	0.00	0.0	07/24	0.79	55.2%	578.4	12.4%	64.7	15.6%	11.2%	3.28	36.7%	244	72.6	39.0	32.8	28.5	9.0	2.7	Invalid	13.7
NVIDIA	0.04	0.0	07/24	0.67	170.2%	30040.0	122.4%	19234.0	175.2%	64.0%	2.13	414.7%	402	156.4	35.0	26.1	17.1	30.0	2.0	1.2	12.8
PaySign	0.00	0.0	06/24	0.01	-	14.3	29.8%	0.9	2,141.3%	6.8%	0.14	460.0%	261	87.1	40.0	30.0	20.0	14.0	1.9	4.2	21.0
Miller Industries	0.76	1.3	06/24	1.78	98.0%	371.5	23.7%	26.2	38.3%	7.1%	6.22	84.6%	86	69.3	15.1	12.4	9.7	8.0	1.1	37.7	21.1
Styeworks Solutions	2.80	2.8	06/24	0.75	38.3%	905.5	15.3%	133.4	39.9%	14.7%	4.83	25.3%	185	109.9	21.1	16.9	12.6	10.0	1.9	2.1	12.1

- ### What About In-Between Projected RV Figures?
- 
- How should Projected RV be interpreted if stock is somewhere in enormous range between 80% & 150%?
 - Simple under-/over-valued framework fails to capture nuance or provide clear guidance for action in portfolio.
 - Especially for stocks reporting non-recurring events or that are in fringes of above ranges.

Redefining Valuation Characteristics

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- ### Moving Beyond “Over-”, “Fairly,” or “Under-” Valued
- 
- Can we capture nuance & provide **better insight** into buy/sell/hold definitions with by redefining/recategorizing stock valuation metrics?
 - When we apply labels, we give meaning & create better understanding—**making sense out of “maybe.”**

My 5 Levels of Stock Valuation

Proj RV Range	Valuation Category
< 80%	Busted Valuation
80% - 100%	Undervalued
90% - 110%	Reasonably Valued
110% - 150%	Overvalued
> 150%	Hypervalued

NOTE: Values exist on continuum, never in absolute numerical ranges, & always subject to interpretation.

Dealing with Busted Valuation Stocks

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Busted Valuation

- P/E-based valuations **cease to provide valid comparisons** when Projected RV falls below 80%.
- Something negative has happened (or is expected to happen) to company fundamentals, so stock has sold off significantly.
- Could be **very severe** overreaction from market, & **may** offer long-term opportunity....
 - But depends on depth & severity of company's problems.
- Even so, market has long memory & may remember problems longer than fundamentals may warrant.

Should Busted Valuation Stocks Be Removed?

- Stocks that have busted valuations may show excellent long-term total return potential on SSG.
- **However, this may be misleading:**
 - Fundamental problems may **outweigh return potential**.
 - May be ideal candidates for **capital loss harvesting**.
 - Should at minimum be **automatic challenge candidates**.
- Use extreme caution when considering these stocks.

Risks of Holding Ultra-Low RV Stocks



- Even if you decide factors affecting company are short-term in nature, market may not agree with you.
 - Once company fundamentals improve, will market respond & lift share price?
 - Short-term problems have tendency to linger in minds of investors, so may be years before valuations recover after problems are “fixed.”
- Buying stocks selling at low prices may be best considered part of **speculative portion** of portfolio.
- Avoid falling into trap of “**How much lower could it go?**”

Put Underperformers “On Probation”



- Companies that have stumbled or for which you are unsure of future prospects can be put **On Probation**.
- This means no action is expected (buy or sell) until more evidence is available, either continued downtrend or recovery.
- As evidence points increasingly towards removal, make stock “Available for Cash” (AFC).
 - Mental trigger to acclimate to removal & find replacement candidates.

Busted Valuation Stocks May Be Speculative



- If after acknowledging problems, want to continue to hold stock even if it’s “long shot” that it will recover, move to “Speculative” portion of portfolio.
- NAIC Founder George Nicholson recommended that 5%-10% of assets be invested in “speculative” portion of portfolio.
 - Segregated from rest of portfolio to protect other holdings from continuing damage, but allowing for big gains from current valuations.

Dealing with Under- & Reasonably-Valued Stocks

Five Levels of Valuation, by Doug Gerlach

Undervaluation



- **Undervalued** = Projected RV between 80% & 100%.
- Stock is selling at or slightly below its average valuation.
- Stocks often sell at 10% - 20% discount to typical levels.
 - Optimal purchase level.
 - High-quality companies may not sell for very long at significant discount to average valuation (IOW, "average" may mean that stock price & P/E fell for single day).
- For consistent-growing companies, buying when undervalued will provide extra boost to total return that will help portfolio returns exceed market over time.

Reasonable Valuation



- **Reasonably Valued** = Proj RV between 90% & 110%.
- Stock is close to average valuation—not especially on sale nor overpriced.
- If fundamentals warrant, can be good time to initiate or add to position.
- Over time, stocks almost always return to these levels.
- **Some high-quality stocks never sell for long at much of discount, so paying ~10% premium may work out well over long-term.**

A Little Discount Would Be Nice



- Buying stocks in **undervalued & reasonably-valued** ranges almost always serve long-term portfolio returns.
- Don't be discouraged from buying well-managed company at slightly-high valuation—it can pay off to **pay for quality**.
 - Warren Buffet: "Better to buy **wonderful company at fair price** than **fair company at wonderful price**."

However, Note These Important Caveats



- Any time stock sells much below average P/E, understand why:
 - Has entire market pulled back?
 - Is sector or industry under pressure?
 - Has competitor/peer hit roadblock, & stock has fallen in sympathy?
 - Is stock "fallen angel" facing temporary issues?

Best Buy Prospects May Be in Your Portfolio



- Investors tend to ignore currently-held stocks when they have capital to deploy.
 - Don't want to increase average basis or lower total return earned from stock.
 - Not confident enough about stock to make additional buy decisions.
- Logically, these are often best candidates compared to other opportunities—***don't pass them by.***

Dealing with Overvalued Stocks

Overvaluation



- **Overvalued** = Projected RV between 110% & 150%.
 - Overvaluation level increases as Proj. RV gets closer to 150%.
- For stocks you own, this is great place to be!
 - Means that valuations have increased since purchase.

Over-Valued Stocks in Portfolio



- If task of company analysis has been done successfully, many stocks will be “over-valued” with above-average P/E ratios.
- These are usually solid “hold” candidates as long as fundamentals are strong.
- In BI's approach, we **never sell purely to lock in profit.**
 - This is like cutting blooms off flowers in garden & letting weeds grow.
- BI suggests holding through periods of overvaluation & “hot” markets.

Use Caution When Buying Overvalued Stocks



- Can be risky to buy stocks at these levels.
 - Ralph Seger: “High P/E stocks discount not only future but hereafter as well.”
- Stocks at high end of Overvaluation stage are often “market darlings.”
 - Don’t jump off cliff just because everyone else is!

Dealing with Hypervalued Stocks

Hypervaluation



- **Hypervalued** = Projected RV >150%.
- When stock reaches approaches this level, price is considered significantly “overheated.”
- Risk from holding is **high**:
 - Level is unsustainable for long-term.
 - Downside risk is very large if something goes wrong.
- Considering these as more than simply “over-valued” helps with portfolio management

Risks of Holding Hyper-Valued Stocks



- Stocks **never stay hyper-valued for very long before pulling back.**
- Risk is that valuations will **regress to mean**, which creates loss on paper (& regrets about what might have been!).
- As a result, these are often **prime replacement candidates.**
- However, hyper-valued stocks have way of **continuing to increase in value**, most noticeably *right after you sell!*

The “Downside” of Investing Success

- Unrealized gains may be high from stocks approaching or at hyper-valuation levels, which can inhibit selling:
 - Realizing gains will generate capital gains & resulting taxes.
 - Selling winners may leave portfolio overloaded with average performers or outright losers.
 - Selling good performers prevents future returns from those stocks.
 - You simply like having big winners in portfolio!

Gain/Loss Harvesting in Portfolio Management

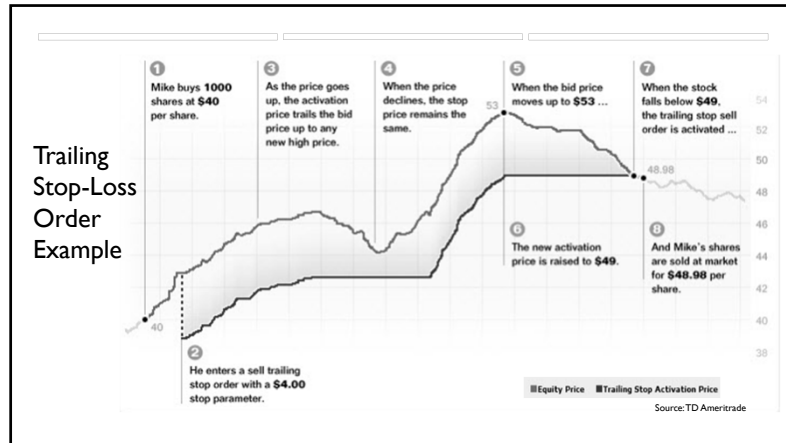
- If portfolio includes **busted-valuation or stocks with unrealized losses & hyper-valued stocks**, then selling to generate offsetting gains/losses takes care of 2 problems at once.
- Consider sale as temporary & revisit sold stock only after 31 days (to avoid wash sale) to reconsider buying again.

Downside Protection from Hyper-Valued Stocks

- Selling stocks at or near hyper-valuation level will work out well in most cases.
- However, if concerned about missing potential future upside, consider using **Trailing Stop Loss Order (TSLO)**.

Trailing Stop Loss Order

- With TSLO, stop price changes as security price changes.
- Stop price can be set in 2 ways:
 - As percentage of current price.
 - As fixed dollar amount less than current price.
- Stop price goes up as stock price goes up, but does not decline when stock price declines.



When Signs Suggest Action for “Maybe Zone” Stocks

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“Sell” Is Four-Letter Word



- Investors often resist selling underperformers due to negative feelings sell action generates.
 - Holding still gives illusion of hope that stock will recover!
- A better approach is to strike “sell” from vocabulary.
- Instead, think “**replace**” or “**upgrade**.”
 - Your portfolio can always be **upgraded**.

Replace or Upgrade Underperformers



- Remove “maybe zone” stocks by **replacing** for higher-quality, higher-total return stocks.
- Excitement around new stock pushes thoughts of prior holding into distant memory & reduces feelings of regret.

Still Unsure? Shift Your Thinking



- Ask yourself why you are holding on to uncertainty
- If you can't immediately reach decision, mark underperformer "**Available for Cash**" (AFC).
 - Then carry out **search for replacement candidates**.
 - Tagging stock helps brain & club members **get accustomed to its removal**.
 - New compelling candidates often provide ample rationale to replace underperformers in portfolio.

Summary of My Strategies for Coping with Maybe Zone Stocks

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Strategies for Coping with "Maybe Zone" Stocks



- Put "**Maybe Zone**" stocks with highly uncertain prospects "**On Probation**" & set plan/timeline for handling.
- Use TSLO on **Hypervalued** stocks to capture future upside but automatically sell on price declines.
- Do buy **Reasonably Valued** stocks when cash & portfolio diversification allows.
- Move questionable or stocks with busted valuations into **Speculative** portfolio.
- Seek to "**Replace**" (not "sell") stocks with uncertain prospects or busted valuations.
- Mark uncertain companies "**Available for Cash**" & seek replacements.



Questions?

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Thank You!



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