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:

1. **Buy**: stocks you believe have satisfactory future upside potential.

2. **Sell**: stocks you believe have significant chances of declining.

3. **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:

    1. **Buy now.** Price looks good & fundamentals are strong.

    2. **Don't buy now.** Price looks high and/or fundamentals are "iffy."

- But there is also a 3rd choice:

    3. 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

ssuming one recession and one business boom every 5 years, calculations are made of how high and how

A HIGH PRICE -- NEXT 5 YEARS

Avg. High P/E _____ X Estimate High Earnings/Share _____
(3D7 as adj.)

B LOW PRICE -- NEXT 5 YEARS

(a) Avg. Low P/E _____ X Estimated Low Earnings/Share _____
(3E7 as adj.)

(b) Avg. Low Price of Last 5 Years = _____
(3B7)

(c) Recent Severe Market Low Price = _____

(d) Price Dividend Will Support   Present Divd. = _____ = _____
High Yield (H)

Selected Estimate Low Price _____ = $ _____
(4B1)

C ZONING

_____ High Forecast Price Minus _____ Low Forecast Price Equals _____ Range. 1/3 of Range = _____
(4A1)   (4B1)   (C)   (4CD)

(4C2) Lower 1/3 = (4B1) _____ to _____ (Buy)

(4C3) Middle 1/3 = _____ to _____ (Maybe)

(4C4) Upper 1/3 = _____ to (4A1) (Sell)

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

(4C2) Lower 1/3 = (4B1) _____ to _____ (Buy)

(4C3) Middle 1/3 = _____ to _____ (Maybe)

(4C4) Upper 1/3 = _____ to _____ (4A1) (Sell)

NOTE: SSG Plus now calls **MAYBE** zone "HOLD" zone.

"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 ÷ Avg P/E)*100`
- On SSG, RV around 100% says "current price is around average levels of past relative to earnings."
  - RV < 100% says is 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)

▸ **Valuation Ratios**

RELATIVE VALUE ?
Current P/E: **34.0** / Average 5 Year P/E: **30.1** X 100 = **113.1%**

PROJECTED RELATIVE VALUE ?
Projected P/E: **29.6** / Forecast Average P/E: **24.0** X 100 = **123.5%**

CUR___ ___RICE (09/06/24): 4__.__

		A	B	C	High A / C	Low B / C	Per Share	P / E 100	P / B 100
⦿ 5 Years ◯ 10 Years									
Year				Earnings					
		High	Low	Per Share					
2020		20	130.8	5.76	35.5	22.7	1.99	34.5%	1.5%
2021		27	196.3	8.05	33.7	24.4	2.19	27.2%	1.1%
2022		34	241.5	9.65	36.2	25.0	2.42	25.1%	1.0%
2023		35	213.4	9.68	36.3	22.0	2.66	27.5%	1.2%
2024		45	309.4	11.80	38.7	26.2	2.93	24.8%	0.9%
5 YEAR AVERAGE			218.3		36.1	24.1		27.8%	
CURRENT/TTM				11.81	38.7	26.2	3.00	25.4%	

5 YEAR AVERAGE PRICE EARNINGS RATIO: 30.1   CURRENT PRICE EARNINGS RATIO: 34.0

Monitoring Value with Projected Relative Value

- Once stock is owned, use **Projected RV** to quickly assess value.
  - `Projected R/V = (Proj P/E ÷ 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

Summary	PERT	Diversification	BETTER INVESTING

Report Details

Any I.C.

Show All entries   Search all columns:

Company Name	Div	% Yield	Est EPS Nxt 12 Mo	EPS Qtr End	EPS $	EPS % Chg	Sales Mill $	Sales % Chg	Pre-Tax Profit Mill $	Pre-Tax Profit % Chg	Pre-Tax Profit % Sales	TTM EPS $	TTM EPS % Chg	Proj PE	Price	Proj RV	Proj 5Yr P/E Ratios Hi	Avg	Low	Est EPS Growth	PEG Ratio	U/D Ratio	% Total Return	Lo Pric
Walmart	0.83	1.1	2.04	07/24 07/23	0.56 0.97	-42.4%	169335.0 161632.0	4.8%	6213.0 10727.0	-42.1%	3.7% 6.6%	1.92 1.73	11.0%	37.6	76.64 9/6/2024	138.4	31.0	27.2	23.3	6.0	6.3	0.1	2.6	
Ollie's Bargain Outl	0.00	0.0	3.58	07/24 07/23	0.79 0.68	16.2%	578.4 514.5	12.4%	64.7 55.9	15.6%	11.2% 10.9%	3.28 2.40	36.7%	24.4	87.31 9/6/2024	72.4	39.0	33.8	28.5	9.0	2.7	Invalid	17.7	
NVIDIA	0.04	0.0	2.56	07/24 07/23	0.67 0.25	170.2%	30040.0 13507.0	122.4%	19214.0 6981.0	175.2%	64.0% 51.7%	2.13 0.41	414.7%	40.2	102.84 9/6/2024	154.4	35.0	26.1	17.1	20.0	2.0	1.2	12.8	
PaySign	0.00	0.0	0.16	06/24 06/23	0.01 0.00	--	14.3 11.0	29.8%	0.9 0.0	2,141.3%	6.6% -0.4%	0.14 0.03	460.0%	26.1	4.17 9/6/2024	87.1	40.0	30.0	20.0	14.0	1.9	4.2	21.0	
Miller Industries	0.76	1.3	6.72	06/24 06/23	1.78 1.29	38.0%	371.5 300.3	23.7%	26.2 19.0	38.3%	7.1% 6.3%	6.22 3.37	84.6%	8.6	57.73 9/6/2024	69.3	15.1	12.4	9.7	8.0	1.1	37.7	21.1	
Skyworks Solutions	2.80	2.8	5.34	06/24 06/23	0.75 1.22	-38.5%	905.5 1071.2	-15.5%	133.4 222.1	-39.9%	14.7% 20.7%	4.85 6.49	-25.3%	18.5	98.82 9/6/2024	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

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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 consideredsignificantly "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).
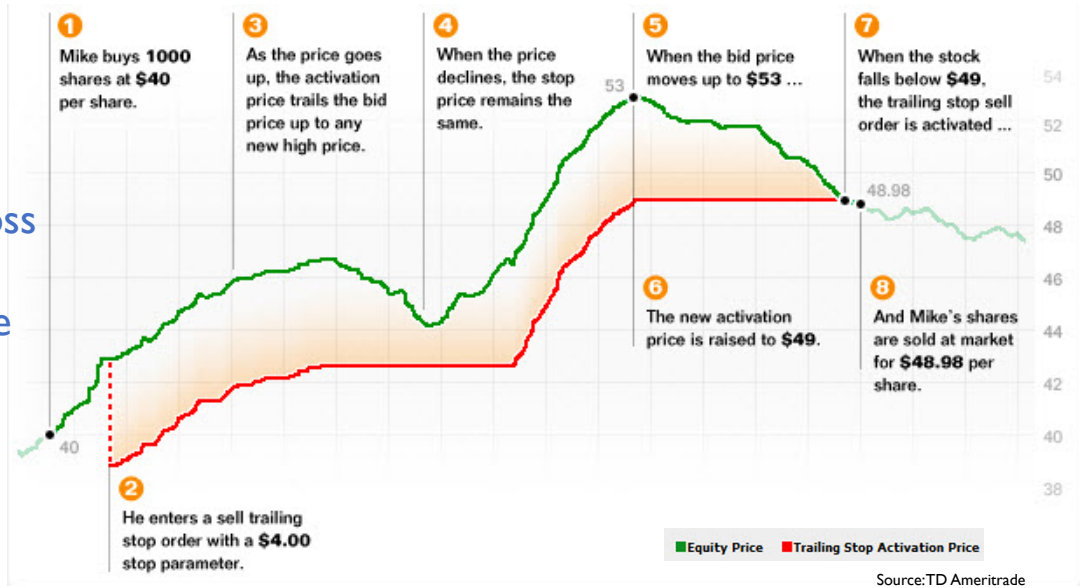
Trailing Stop Loss Order

- 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.

Trailing Stop-Loss Order Example

① Mike buys **1000** shares at **$40** per share.

② He enters a sell trailing stop order with a **$4.00** stop parameter.

③ As the price goes up, the activation price trails the bid price up to any new high price.

④ When the price declines, the stop price remains the same.

⑤ When the bid price moves up to **$53** …

⑥ The new activation price is raised to **$49**.

⑦ When the stock falls below **$49**, the trailing stop sell order is activated …

⑧ And Mike's shares are sold at market for **$48.98** per share.

■ Equity Price ■ Trailing Stop Activation Price

Source: TD Ameritrade

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 are 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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