

Considerations When Selling.

A thought for profit-takers.

“The most powerful counter-argument for preserving your portfolio is to defer capital gains tax on profits. Until you sell, you have a hidden asset in the form of uncalled tax liabilities. US investor Warren Buffett views this tax float as his secret weapon in amassing his personal fortune of more than \$US10 billion. His aide, Charlie Munger, told Forbes magazine last month: There are huge advantages for an individual to get into a position where you make a few great investments and just sit back. You’re paying less to brokers. You’re listening to less nonsense. Best of all, you don’t have to pay off the tax collector every year.”

Strategies for surviving squalls, Tony Thomas, BRW August 1999

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“The price you pay determines your return”
Warren E. Buffett

Our previous notes “**10 steps to beat the All Ords**” and “**How to avoid the headline share collapses**” are written with a focus on purchasing shares and educate the reader about the methods available to invest in companies directly.

This note discusses some of the considerations that must occur when selling a share in a listed business.

For many investors who wish to adopt the intrinsic value method of investing in shares when the price is at a discount to intrinsic value, the logical place to sell is when the shares reach intrinsic value. This is the method that investment managers in the US such as Tweedy Browne adopt. Another method that Benjamin Graham espoused, was to sell when the shares rose 50%, or after two years, whichever came first.

At Clime shares held on behalf of clients in the Contrarian Value private portfolios may only be sold on the anniversary of the date of purchase and only if the criteria used for selection are no longer met by the company in question or the price of its shares. The model determines the time of sale.

The permanent Value portfolios however take a different approach and the decision to sell is a more subjective one. This note examines a major issue that must be considered when selling shares particularly when an unrealized profit has been generated.

In considering the possible sale of a company’s shares, we calculate the effect of capital gains taxes that would be and the net value that would be received if the shares were sold and capital gains tax paid. The net value received must then be compared to the price of the shares intended to be purchased.

Consider the following example where an investor is considering selling shares in National Australia Bank and intends that the shares be replaced with shares in XYZ Company. The investor is a salaried employee already earning \$50,000. (Prices and multiples have been changed for educational purposes and do not reflect the actual prices and multiples in the markets of these securities).

INVESTOR CONSIDERS SELLING NAB

NAB share price (Nov 20, 2002)	\$35.00
Less purchase price (February, 1990)	(\$6.00)
Equals unrealized capital gain	\$29.00

Less capital gains tax if shares were sold.

(Note: 50% discount applies, so effective rate 21.75%) (\$6.31)

Equals realized gains net of taxes \$22.69

After tax proceeds from sale of NAB (\$22.69 + \$6.00) \$28.69

Gain required to get back to having \$35.00 per share

working for the investor $((\$35 - \$28.69) / (\$28.69)) =$ 21.9%

FUNDAMENTALS OF NAB

Estimated Future Earnings Growth Rate	7%
Earnings Per Share	\$1.18
P/E Ratio at current market price	29.66 times

After tax P/E if shares were sold for proceeds of \$28.69 24.31 times

Remember by paying tax of \$6.31 per share, the investor has foregone capital that was otherwise an interest-free loan from the tax office that could be used to compound gains if the shares were never sold.

INVESTOR CONSIDERS BUYING XYZ Ltd

FUNDAMENTALS OF XYZ

Estimated Future Earnings Growth Rate	7%
Price Earnings Ratio	25 times

In the above example both companies have the same estimated growth rates for earnings of 7%.

You will notice that the shares in company XYZ are cheaper than those in NAB. NAB is trading on a P/E of almost 30 times, while shares in XYZ are at a Price Earnings multiple that is 16% lower at 25 times earnings.

Initially selling NAB and buying XYZ seems like a sensible decision. Comparing the after tax P/E of NAB to the purchase price earnings ratio of XYZ reveals they are about the same. On top of this, there is the loss of \$6.31, which could have been retained tax free and compounded.

An investor faces the following choices:

One:

Keep NAB shares whose earnings are expected to conservatively grow at 7% p.a. and invest \$28.69 of her own money and invest \$6.31 of the tax offices money which is an interest free loan. If you don't sell and structure your affairs correctly, the \$6.31 loan will be forgiven upon your death and will be extra money that your family will receive.

Two:

Buy XYZ Limited. You will first have to sell NAB for \$35.00, pay \$6.31 in taxes, which leaves you with \$28.69. Unfortunately to get back to a position where you have \$35.00 working for you, your investment in XYZ needs to rise from \$28.69 to \$35.00 or almost 22%. That means that the P/E ratio of XYZ Limited would need to rise from 25 times to 30.5 times earnings (assuming it happens before the next preliminary final statement or interim statement is released). If the shares do rise and you decide to sell, there will be further tax to pay on this subsequent capital gain.

Given the above choice for the investor, holding on to NAB appears to be the better decision assuming of course it is an outstanding business in every sense. The investor may consider selling if they can find another company to invest in that has excellent prospects and is cheaper. For example another company at 9 times earnings, with a conservative estimate for earnings growth of 15% would be more compelling.

While buying and selling can make you rich, buying and holding will make you wealthy. Indeed most of the wealthiest Australian's fortunes have come from owning businesses that increased in value at a high rate over a long time. Buying shares in an outstanding business should be treated the same way, tax considerations aside.

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November 2002