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Investors should ‘re-buy’ their portfolios every day

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There is a natural tendency for investors to devote a significant majority of their time to finding new ideas. After all, uncovering great companies selling at great prices is the lifeblood of successful investing.

But in the never-ending quest for the next great idea, investors often give short shrift to their existing investments. While everyone would love to have that perfect portfolio of stocks that can be bought and held for ever, it usually does not work out that way. Markets, technology and businesses change too quickly to put portfolios on autopilot.

Successful investing, then, requires that difficult decisions be made all the time about what one already owns. This is not an argument for rapid-fire trading, as the right decision is often to do nothing. But it does require a conscious effort on the investor’s part constantly to “re-buy” his or her portfolio every day. As Lee Ainslie of Maverick Capital recently described it to Value Investor Insight: “One thing I learnt from Julian Robertson [Ainslie’s former boss at Tiger Management] is the concept that there are no ‘holds’. Every day you’re either willing to buy more at the current price or, if you aren’t, you should redeploy the capital to something you believe does deserve incremental capital. I sometimes hear: ‘If my target price is $45, why should we sell at $43?’ The answer is simple: I believe we have better uses for that capital than getting the last few percentage points in the move from $43 to $45.”

Such vigilance is equally important in cases – often faced by value investors – when a laboriously researched stock proceeds to plunge after its purchase. As Rich Pzena of Pzena Investment Management says, “The biggest way you add value as a value investor is how you behave on those down-25-per-cent situations. Sometimes you should buy more, sometimes you should get out and sometimes you should stay put.” When I asked Pzena what he most often did in such cases, he estimated that he bought more, sold and did nothing in roughly equal proportions.

When reviewing one’s portfolio, it is important to be aware of common mental mistakes that may lead to bad decisions. The most powerful is commitment bias, which, as manifested in investing, is the tendency to fall in love with one’s stocks. Numerous studies have shown that investors tend to disregard any information that challenges their investment thesis. As Robert Cialdini summarised in his fabulous book Influence, humans have a “nearly obsessive desire to be (and to appear) consistent with what we have already done. Once we have made a choice or taken a stand, we will encounter personal and interpersonal pressures [that] will cause us to respond in ways that justify our earlier decision.”

Even the world's greatest investor, Warren Buffett, acknowledged falling into the commitment trap in his 2003 annual letter. Referring primarily to Coca-Cola and Gillette – companies that he had earlier labelled as "inevitables" – he wrote: "I made a big mistake in not selling several of our larger holdings during The Great Bubble. If these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far higher. So do I."

Other common mental mistakes include loss aversion – studies show that investors feel the pain of loss twice as much as they feel pleasure from an equal gain – and anchoring on the price paid for a stock. These two mistakes often result in a refusal to sell at a loss, even if the original investment thesis is in tatters. As the investment legend Phil Fisher wrote in Common Stocks and Uncommon Profits, "More money has probably been lost by investors holding a stock they really did not want until they could 'at least come out even' than from any other single reason."

Even the most experienced investors can fall into these traps, so what do they do to avoid them? Maverick's Ainslie distributes to his analysts every day a "Sheet of Shame," which shows the firm's 10 largest losses since original purchase, year-to-date, month-to-date and for the previous day. "There are only two ways to get something off the Sheet of Shame – which people are eager to do: either eliminate the position or increase the position and be right, earning some of the losses back," he says. Another technique, used by Greenlight Capital's David Einhorn: if he's thinking he should trim or sell a position entirely, he sells a few shares, sleeps on it and then sees how he feels about it the next day. Often, he finds, he feels great about the sale, which is a strong sign that he should keep selling.

The variety of potential biases that can impact how you evaluate your existing portfolio make it all the more important to review the stocks you already own with the same rigour and discipline you apply to new ideas.

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