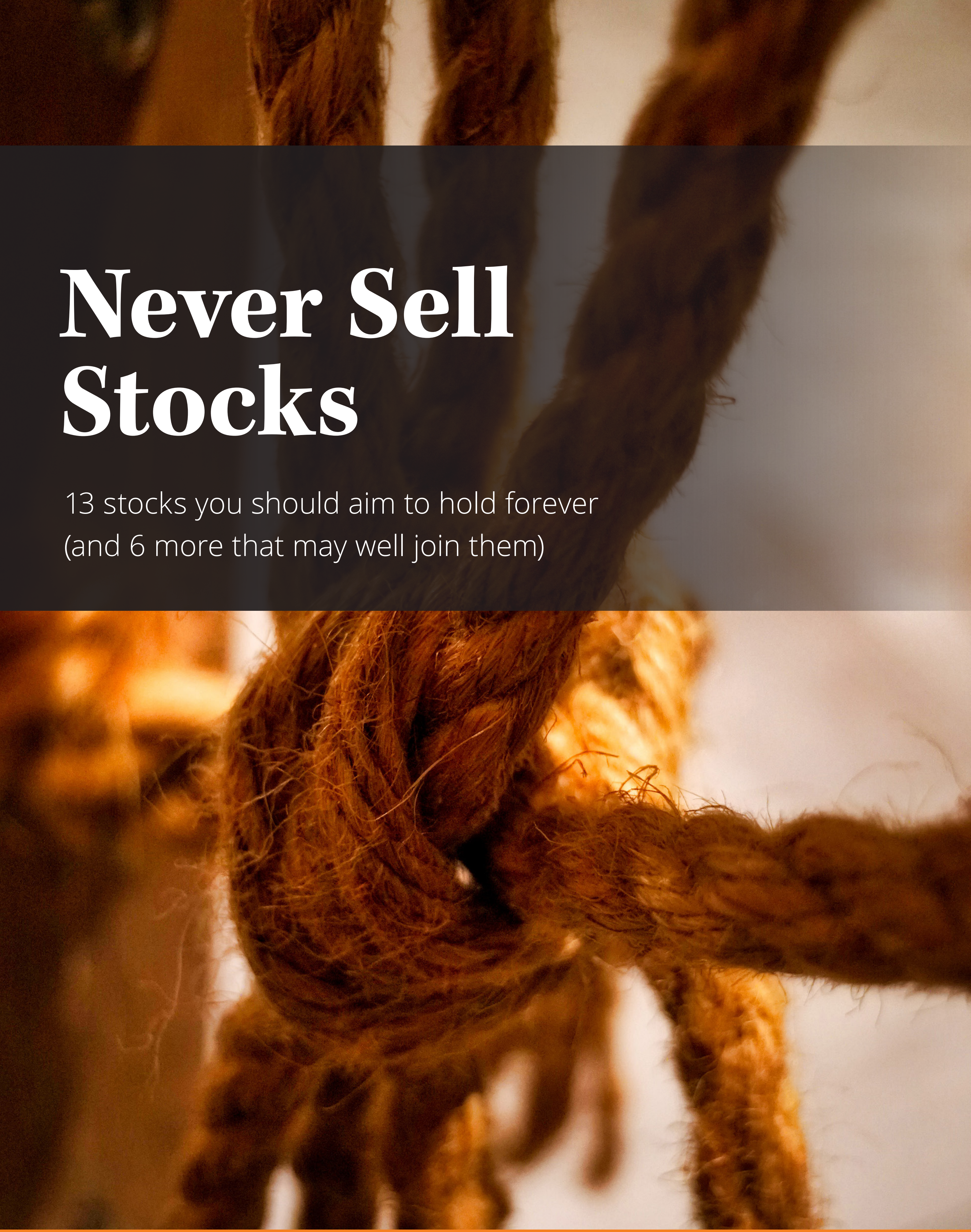

Never Sell Stocks

13 stocks you should aim to hold forever (and 6 more that may well join them)

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About Us

With a 20-year track record of beating the market, clear and straightforward language, and an 'open book' approach to stock research and analysis, *Intelligent Investor* offers actionable, reliable recommendations on ASX-listed stocks.

In 2014, *Intelligent Investor* became a part of the InvestSMART family, extending our expertise to even more Australian investors seeking quality analysis and advice.

About the author

John Addis founded *Intelligent Investor* in 1998. Having returned as the editor of *Intelligent Investor* after selling the business in 2004, John now gets to indulge his favourite interests: the shape and form of words; investing psychology; the odd, fascinating and frustrating world of macroeconomics; and great stock opportunities.

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What ASX-listed stocks should you never sell?

Can you make 500% on a stock and still call it a mistake? Oh, yes you can. And we have the proof.

By John Addis, founder and editor, *Intelligent Investor*

Over the last 20-odd years we've recommended companies that have gone bust (Timbercorp), changed our minds on former buy recommendations and locked-in a loss (**Unibail**), been late to spot under-investment in product (**GBST**), fallen in love with management (Roc Oil) and got our numbers wrong (Timbercorp again).

Although it rarely occurred, in each case the worst possible outcome was a total wipeout. What could possibly be worse?

Loss aversion aside, how about **Cochlear**, a five-bagger over the four years from when we initially recommended it on **3 Jul 98** (Buy – $6.30)? Locking in profits in 2002 seemed sensible, especially with an apparently high valuation. And anyway, who could possibly be dissatisfied with a 550% gain?

Every *Intelligent Investor* analyst, apparently. Having asked them to nominate our greatest investing mistake over the past few decades, selling out of great businesses got number one spot, with Cochlear the prime example.

Had we managed to set aside our concerns about valuation, that five-bagger would have become a 32-bagger. You can add up all the losses from the likes of Timbercorp, Unibail, Roc Oil and GBST etc. and all would have been overcome by this one fantastic gain. This was the key lesson six years ago when Research Director **Nathan Bell confessed his worst calls ever**.

Great investment track records tend to be determined by a few great ideas. Murray Stahl analysed Peter Lynch's famous track record of earning 29.2% p.a. between 1977 and 1990, with a view to understanding how a portfolio containing 1,400 stocks could do so well. Surely a thousand plus stocks would be a proxy for market returns?

Instead, Stahl found that just two stocks, both of which emerged from bankruptcy, accounted for most of the performance. That's two stocks in 1,400.

Our track record, good as it is, would be more impressive had we hung on to Cochlear. In our defence, we have jumped back in a number of times over the last 15 years, but at the expense of the many advantages of holding great stocks for the very long term.

These extend well beyond the old saying that good things tend to happen to good businesses.

As Graham Witcomb wrote in ***Why the dead outperform the living***, "A University of California study of 66,000 investors found that the higher the portfolio's turnover, the lower the average return. Those who traded the most lagged the overall market's performance by 6.5%. As the researchers put it, 'trading is hazardous to your wealth".

Hanging on to good businesses lowers transaction costs and allows a growing company to compound your investment over time. Cochlear is a great example.

The second advantage is covered in James Greenhalgh's ***Till death do us part – my never sell list*** who wrote that:

"Selling apparently highly priced but excellent businesses has usually turned out to be a long-term mistake. Wonderful companies can end up creating value over time in surprising ways, whether through internal investment or acquisition. Often it's simple mathematics. Companies that can reinvest capital at high rates of return can compound value significantly over time".

Selling out usually triggers a tax liability that reduces the impact of compounding.

The third is via Nathan, who makes the point that "it's difficult and time consuming to keep finding new opportunities to earn high returns after paying tax on your gains from previous ideas".

Selling companies you know inside out to buy companies you're less familiar with is risky because of what Nathan calls 'shiny new toy' bias. "People overestimate the value of new ideas over old ones simply because they're more mentally stimulated by new ideas."

That's something we were perhaps guilty of in the case of Cochlear. High growth over many years is more valuable than most people realise; selling such opportunities on concerns over valuation alone is usually a mistake.

Whilst Cochlear was our clearest mistake in this regard, we have done better elsewhere. Having recommended **CSL** on **20 Jan 10** (Buy – $31.30) we've held on up to $300. As Graham Witcomb notes in the **most recent review**, "CSL can't be valued on its current earnings alone – its competitive advantages and long, steady runway for growth are where most of the value lies."

The lesson, in the words of Gaurav Sodhi, "is to think about business strategy and competitive position more than you think about statistical cheapness." Or apparent expense.

Adopting that mindset has allowed us to make substantial gains on high quality businesses like CSL, **ResMed**, **ASX** and **Sydney Airport**. Our track record on **Sonic Healthcare**, **Macquarie Group**, Cochlear and **ARB**, where one small, caveated Sell recommendation was arguably a blemish, is less distinct.

Almost every company faces structural challenges. It would therefore be foolish to say there are stocks that one should never, ever sell. But it makes sense to at least have the intention to own high quality companies with deep competitive moats forever. This isn't to disregard valuation, but to weight it appropriately, in the manner of Graham's comment on CSL.

It is also to make the point that a few high performing stocks will likely account for most of the returns in your portfolio. Such stocks are more likely to be high quality businesses that can compound returns at impressive rates over long periods. The eternal problem is that we can't possibly know exactly which stocks will be the high performers.

If a few good choices will make most of your money and you can't pinpoint them it makes sense to at least have a mental list of those companies most likely to jump the high quality bar. With that in mind, our never-sell stocks are:

1. **Cochlear**
2. **Macquarie Group**
3. **ARB**
4. **ASX**
5. **Realestate.com.au**
6. **CSL**
7. **James Hardie**
8. **Sonic Healthcare**
9. **Wesfarmers**
10. **Seek**
11. **ResMed**
12. **Sydney Airport**
13. **Reece**

Of course, this does not mean one can 'set and forget' an investment portfolio. Businesses and the environments in which they operate change and sensible investors leave the door open to reassessment.

The 13 stocks listed above are companies where we have the "intention" to never sell; high quality companies with deep and enduring competitive moats that we could take to the grave and whatever lies beyond.

None of the stocks nominated found a place on our current **Buy List**. The aim of getting readers to focus more on competitive advantages over time than valuation at a point in time is an important one.

It does, however, raise a further issue. Once one accepts that interest rates are going to remain low for a long time, as suggested in ***What to do about a world turning Japanese***, and that our preferred holding period is forever, what other stocks might one day earn a spot on a Never Sell list?

That was the question I posed to our analytical team, one where the constraints were calculated to influence their decisions more than current stock valuations. If you have to buy a stock now, can't sell for a decade and don't care whether returns come from capital appreciation or dividends, the mind inevitably turns to business quality.

Why? Because if a business can successfully reinvest capital over a decade at a rate of return far greater than current rates of interest, there will be a tendency to grow and eventually exceed what might appear to be a currently-high valuation.

Here's a summary of the six constraints posed on the team's responses:

1. Interest rates will stay below 2% for a decade;
2. You want to own businesses with enduring competitive advantages;
3. You don't care whether the returns come from capital appreciation or dividends;
4. You have to buy at least one stock now and can't sell it for 10 years;
5. It can't already be on our Never Sell List;
6. It can be a current Buy or a Hold;

And here are their stock selections incorporating them:

COMPANY (ASX CODE)	PICKED BY	LATEST RECO.	PRICE AT 22/1/20	BUY BELOW
Carsales (CAR)	NB	26 Aug 19 (Hold – $15.50)	$18.16	$12.00
Crown Resorts (CWN)	NB	22 Aug 19 (Hold – $11.48)	$12.15	$8.00
Tabcorp (TAH)	NB, GW	3 Oct 19 (Buy – $4.75)	$4.75	$5.00
WH Soul Pattinson (SOL)	GS	27 Sep 19 (Hold - $21.06)	$22.46	$17.00
Commonwealth Bank (CBA)	JG	9 Aug 19 (Hold – $79.25)	$84.45	$60.00
Equity Trustees (EQT)	MM	1 Jul 19 (Hold – $30.87)	$31.20	$28.00

Nathan Bell (NB), research director

My three stocks include two sin stocks – **Crown Resorts** and **Tabcorp** – and global online car classifieds company **Carsales**. Carsales is the dominant provider of second hand car leads for dealers while its fledgling businesses in emerging markets should be much larger and more profitable businesses in a decade's time. The risk is that its high levels of profitability attracts competition, although network effects should offset that.

The sin stocks benefit from long, government-issued licenses, increasing tourism and population growth. Crown has clear plans to grow in the years ahead with its Barangaroo development in Sydney due to open this year while Tabcorp's lottery business should grow consistently regardless of economic fluctuations as more people spend more money buying tickets online.

The risk is that its high levels of profitability attracts competition, although network effects should offset that.

Although its wagering business faces competitive pressure that may or may not abate, the current ~20% of lottery tickets sold online is less than half that sold online in many other countries. Given the predictability of this trend, I'm going with Tabcorp.

Gaurav Sodhi (GS), deputy research director

As value investors we get hooked on the idea that valuation is the basis of future returns. Increasingly, I'm of the view that it matters more in some cases than in others. Some businesses have such enduring advantages that we should think less about value today than about long term value. We all need to remind ourselves to think in those terms when we are tempted to seek out superficially cheap stocks.

Never sell are big words and I'm probably less taken by the concept than others in the team.
While I agree that strong moat businesses deserve leeway, I would still consider most companies at the right price. Very few have the deep, growing moats of, say, **REA**, **Seek** or Sydney Airport. Just think about businesses that were considered impenetrable in the past, including newspapers, banks and cable companies. All have been disrupted and what might have been a 'never sell' turned into a 'never hold'.

> **With a great track record, a long term focus and a willingness to buy and sell assets as value dictates, this is one way to stay flexible while still maintaining exposure to quality.**

I'm therefore cautious about the stocks I nominate in this category. Having mentioned Seek twice now, and considering the quality of the original never sell list, I've found it hard to come up with a replacement. So I'm going to cheat. Sort of.

My nomination is **Soul Pattinson**. It's cheating because Soul Patts is a capital allocator more than it is a conventional business. With a great track record, a long term focus and a willingness to buy and sell assets as value dictates, this is one way to stay flexible while still maintaining exposure to quality.
I know we have issued a Sell call in the recent past but if you are compiling your own never sell list, this business deserves consideration.

James Greenhalgh (JG), analyst

I'm a big fan of having a 'never sell' list. The 'never sell' stock that I hold in my personal list – that's not on *Intelligent Investor*'s official list – is **Commonwealth Bank**.

This might seem surprising for two reasons. One, I'm not a bank stock 'fan boy' – Commonwealth Bank is the only bank I own (apart from **Macquarie Group**, which isn't really a proper bank). There's certainly 'earthquake' risk here – every decade or three a banking crisis occurs. That sliver of equity supporting all those loans can get wiped out very easily in a crisis, taking shareholders out with it.

My second reason relates to a criterion for this exercise; that interest rates will stay below 2% for a decade. That implies a lack of credit growth and pressure on net interest margins, which will make life tough for banks, which can only drop deposit rates to zero.

That said, Australia's big four banks are phenomenal businesses. Together, they control more than 80% of the country's mortgage lending. While there are some threats from technological change and funding risks, I'm willing to bet Commonwealth Bank will be a bigger bank in 2029.

It might even emerge stronger after a downturn, as it did following the acquisition of Bankwest during the Global Financial Crisis. Commonwealth Bank might well be called upon to acquire a weaker bank again if the need arose.

> **While there are some threats from technological change and funding risks, I'm willing to bet Commonwealth Bank will be a bigger bank in 2029.**

Yes, banking stocks are inherently risky, but it would have to take a lot for me to sell my stock. For me, Commonwealth Bank is a 'never sell'.

Graham Witcomb (GW), analyst

I considered Tabcorp for the Never Sell list but it's definitely my pick for this one. There are plenty of scenarios where I would want to sell the company's wagering division but with around half of company earnings coming from its monopoly as Australia's lottery provider, this operation is the next best thing to owning the Royal Australian Mint.

Around 80% of this division's earnings are from exclusive licenses that stretch out to more than 30 years. The Government also recently made clear that it would defend licenses by banning imposter 'synthetic lotteries'. Tabcorp's earnings are therefore very sturdy due to the fixed profit margin built into its games, the public's unending appetite for lotteries (even in recessions) and its long-dated exclusive licenses, with practically no direct competition.

Tabcorp isn't quite in the league of Sydney Airport or CSL; its wagering division and debt add an extra layer of risk, as does its Victorian lottery licence, which resets every 10 years. Plus, the 30-year license expiry means 'never sell' is too strong.

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However, the stock's current valuation and 4.6% dividend yield goes some way to offsetting those risks. Tabcorp has many competitive advantages and will almost certainly be a bigger, stronger company 10 years from now. With luck, management may spin off the wagering division, giving investors a shot at owning a standalone mint.

Mickey Mordech (MM), analyst

My choice is trustee-services provider Equity Trustees. On a 3.8% free cash flow yield, this stock isn't clearly cheap but I expect high single-digit growth over the coming years; in a world of 2% rates, that seems more than adequate to justify the current valuation.

The company's private wealth division helps high net worth individuals, superannuation administrators and philanthropic trusts with things like estate planning and establishing and managing trusts, while the corporate division acts as a responsible entity for managed funds.

It's boring work, but it's probably one of the closest things to an annuity stream that exists on the ASX.

It's boring work, but it's probably one of the closest things to an annuity stream that exists on the ASX. Barriers to entry are high; because margins are tiny, a would-be competitor needs to amass billions in funds to become profitable. This has driven consolidation across the sector, leaving just three competitors in private wealth and two in corporate services. It isn't a monopoly but it is the next best thing; an oligopoly.

Equity Trustees also benefits from scale advantages, high barriers to entry, a favourable regulatory environment and annuity-style income. Barring a lawsuit, irrational competition or a market collapse, it should grow earnings consistently over time, making it the kind of defensive stock that should fare well over the next decade.

Disclosure: Of the stocks mentioned by our analysts, MM owns EQT, JG owns Commonwealth Bank and Macquarie Group and GW owns Tabcorp. All prices correct as at close on 22 Jan 2020.

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