Manager Perspective

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TANDEM
WEALTH ADVISORS

NOVEMBER 2012

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Many investment managers tell you how they select stocks to buy. Very few can concisely explain their sell discipline. At Tandem Wealth, we have a clear, concise sell discipline that is readily explainable. Below, we explain two recent sell decisions and how we decided to remove these stocks from client portfolios.

Sell Discipline 1 – Stock surpasses fair value target price

Abbott Labs (ABT) – We sold ABT out of client portfolios recently. ABT was originally purchased in the Spring of 2009 for approximately $41-43 per share. At the time, we believed the intrinsic value of ABT was approximately $55 per share based on 2010 earnings estimates. As time progressed, we began to look at 2011 and then 2012 earnings estimates. Rising sales and earnings at the company, and a generally positive environment for healthcare stocks, kept us feeling very positively about ABT and its prospects. We slowly and methodically raised our price target on the stock during the ensuing three years.

In mid-2012 we began to formulate our 2013 earnings forecast for ABT. Based on the information available we felt earnings growth would slow to approximately 4-6% in 2013 and this is how we arrived at our target price in the $62-64 range. The stock continued to perform strongly and when it surpassed our price target, we sold the stock out of client portfolios in the high-$60s to low $70s. This gave us a gain of approximately 60-65% in most client portfolios that held the stock for the full 3 ½ year period.

ABT has subsequently retreated along with the broader market and is currently selling at $63. This is close to our current fair value target. Were the stock to decline further into the mid-$50's it would become more interesting to us once again and we would re-evaluate it for client portfolios.

ABT is a classic example of holding a stock for several years and constantly evaluating forward earnings, P/E multiples, and fair value. When the stock exceeded fair value, we sold the stock, locking in a very nice profit for clients.

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Sell Discipline 2 – Fundamental reason for stock purchase no longer valid

Hewlett-Packard (HPQ) – We recently sold HPQ from client portfolios. This was not an easy decision as we still believe there is value at the company. Sales were made in the $14-17 range.

Why did we sell the stock if we believed there was value? At the recent analyst day, CEO Meg Whitman described 2013 as another transition year as the company moves to become leaner and more profitable. However, the "new" information we got was that the transition isn't expected to be completed until the end of fiscal year 2014. Having been in this business for decades, we understand that the stock will turn 6-12 months before tangible proof of a turnaround is evident. We also acknowledge that even on the depressed earnings estimates, HPQ is very cheap. That said, we believed the stock could still get a lot cheaper and has all the potential signs of a value trap.

If we back out restructuring costs, FY2013 EPS are projected to be in the range of $3.40-$3.50. This is well below the prior consensus estimate of $4.18 per share. That alone is not reason to sell as the stock was valued at just over 4x these estimates when we sold. What concerned us is that management said that every division within the company will have a difficult FY2013. Many of HPQ's competitors have had a favorable sales mix for years – skewed towards higher margin services and this has allowed them to build up cash on their balance sheets. HPQ is very late to the services game and has spent recklessly on acquisitions, particularly on the 2011 purchase of Autonomy which was extremely overpriced in our opinion. These acquisitions and focus on low-margin businesses has caused HPQ to spend cash and pile on debt.

In sum - the near-term picture at HPQ is very cloudy. Cash flow should remain relatively strong, and the company has said it would like to pay down debt as quickly as possible. With the company being a net debtor and spending about $1 billion annually on stock dividends, this may be a challenge. If we look back to the 1992-1994 turnaround at IBM, it was less than 12 months after a management change that the stock bottomed. Shareholders that bought when Mr. Gerstner came aboard made multiples of their investment over the next 10 years. Is this possible at HPQ? Yes, but less likely because we aren't sure HPQ has the same strength in its businesses. Turnarounds tend to be underestimated in both difficulty and duration, so HPQ's stock could lag for several more quarters or years.

We do believe that there will be a time to own HPQ – and that time may be as early as at some point in 2013. However, at this point, we felt it prudent to sell the stock and book the tax losses for client portfolios in 2012 to help offset gains. We can now monitor HPQ's earnings reports and other announcements before deciding when and if to re-enter the stock.

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