There is a lot of literature out there on investing that mostly focuses on buying decision. However, you would find very limited discussion on what to do once you have bought i.e. when to sell. Possibly the reason for it could be there is no correct answer to this question. We would like to approach the sell decision through a different route. Thus rather than focusing on when to sell we would like to address this by answering the question – How long to stay invested? We believe if we try to bring in a disciplined approach to our sell decision in addition to the buy decision, we would avoid the behavioural pitfalls that most investors have to go through.

But before we go into that discussion, let us first try to understand what drives returns in equities.

Investing in Equity is like part ownership of a business. Thus unlike a fixed income instrument that generates a fixed coupon, in equities your fortunes are linked to how the business performs. At the same time, your fortunes are also linked to what the market perceives is the value of this business. Thus in essence there are two factors that are driving your fortunes – how the underlying business performs and what is the market's perception of the value of the business. Thus your equity return from a stock would be equal to the growth in underlying business/earnings and the valuation rerating/derating that takes place during your holding period.

For example lets assume you bought a stock today at Rs.100 whose EPS is around Rs.10. Basically you have paid 10x earnings or PE ratio of 10 for the stock today. Now let's assume you held on to the stock for 5 years. During this period let us assume the EPS of the company has grown at 10% thus taking the EPS to 16.1 at the end of 5 years. Now if we assume that you are able to sell that stock at 20x PE ratio in the market, you would be selling the stock at ~Rs. 322. Thus you have generated a CAGR of 26.4% from 100 to 322 in five years. Now if you breakdown the return into the two factors that we had discussed earlier, the underlying business growth helped us to get the 10% CAGR and the balance return out of the 26.4% CAGR was due to rerating in the stock that took place from 10x PE to 20x PE in 5 years.

Between the 2 factors valuation plays a major role in your returns in the shorter period while the underlying business growth plays a major role in the returns in the long run. If we take our earlier example forward and keeping the assumptions same if we just expand the timeline of exit you would see which factor has more influence over different time horizons.

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Holding Period (Years)	Underlying Growth	Valuation Rerating (From 10x PE to 20x PE) CAGR	Total CAGR
5	10.0%	14.9%	26.4%
10	10.0%	7.2%	17.9%
20	10.0%	3.5%	13.9%
30	10.0%	2.3%	12.6%

As you can see, longer the holding period, higher is the influence of underlying growth of business and lower the influence of valuation rerating. The holding period of a stock should be a factor of the underlying growth in business and conviction that one has on the sustainability of that growth.

Longer holding periods are thus best fit for businesses that have very strong underlying business growth and visibility of the same. “Visibility” is a factor of underlying industry growth rate and ability of the business to maintain or grow market share i.e. sustainability. A strong business which is able to create barriers to entry for competition (or Economic Moats as Warren Buffett puts it) would be best placed to exploit the underlying industry growth rate and defend or grow market share. Thus such businesses should have the longest holding period as they would continue to grow without being affected by competition.

Next are businesses in an industry which has some sort of an advantage that allows them to grow at a good pace on account of a medium term opportunity/tailwind – which could be either a consumer preference shift (e.g. motorcycles to scooters), unorganized to organised, patent cliff in case of generic pharmaceuticals, technology shift, etc. We term these companies as Advantage companies. The advantage companies might not have very strong barriers to entry, but the strong tailwind provides good growth over medium term. Such companies can be held as long as there is visibility of the underlying trend continuing. There could be a point where these companies may be valued by the market as if they have very strong barriers to entry and significant part of the growth opportunity is being priced in, at such points one should evaluate whether it makes sense to continue to hold or exit.

Lastly there are companies that may not have any of the above characteristics. These companies need to be looked at purely from a valuation perspective. Both the buying and selling decision would be purely driven by valuation as the underlying growth might not be significant or reliable. If you buy a business which has very low underlying growth and no competitive advantage, then valuation rerating has to do the heavy lifting in order to deliver a reasonable return. In our earlier example, if we assume that underlying growth in the

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business was zero, then CAGR delivered by valuation rerating would have been the return that you would have generated for each of the holding periods mentioned in the table. As you can see the return in the 5 year holding period is ~15% while for a 30 year holding period it drops down to 2.3%. Thus longer the holding period to realise the valuation rerating that you were seeking, lower would be the CAGR return.

At Multi-Act our focus is on differentiating companies into above categories (Companies with competitive advantage – or Economic Moats, those with medium term tailwind – Advantage companies and the rest) so that we have clearer understanding of when to buy and how long to hold.

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