January 25, 2021

Banyan's equity composite gained 13.2% in 2020, but hold your applause. The S&P 500's total return was 18.4% for the year. The tech-laden NASDAQ 100 did even better with a gain of 48.9%. Bitcoin, an ideal vehicle for speculation, gained over 300%. The Dow Jones Industrial Average, meanwhile, gained "only" 9.7% weighted down as it is by old-school outfits like 3M and IBM.

Taking a longer-term view, Banyan's equity composite gained a cumulative 49.7% over the three years ending in 2020 compared to the S&P 500's cumulative return of 48.9%. Our performance going back to inception can be seen below (or click here to see our Equity Composite in full):

Equity Performance Summary - Total Returns

Annualized / Compounded Returns

		Last 12 Months	Last 3 Years	Last 5 Years	Last 10 Years	Last 20 Years	Since Inception
Banyan	Gross of Fees	13.2%	14.4%	14.3%	12.8%	7.9%	11.8%
	Net of Fees	12.2%	13.4%	13.3%	11.8%	6.9%	10.8%
S&P 500 Total Return		18.4%	14.2%	15.2%	13.9%	7.5%	10.7%

Most investment literature focuses on the positive art of buying assets. Literature on the negative art of selling is sparse. This makes sense. Great investors do not sell their way to prosperity. It is a largely positive journey that goes something like this: Identify a company with a great business, good management, and a fair price. Buy it and hang on tight as it compounds on your behalf.

But when is selling justified, if not necessary? This is a surprisingly difficult question to answer in a practical way. It is also critically important. In fact, poor sell decisions have likely cost Banyan clients more over the years than poor buy decisions. Had we not sold Amazon in 2019, for example, Banyan clients would have been at least $3 million richer at the end of 2020 *excluding* the tax bill.

Of the various reasons to sell, only one is subject to much debate – valuation. Many successful investors sell if they believe an asset is "overvalued." Others, recognizing the ambiguity inherent in valuation, *never* sell due to valuation alone. The latter view is held by Chuck Akre, the very successful founder of Akre Capital Management. His lieutenant, Chris Cerrone, put it this way:

> "*We [at Akre Capital Management] are unfazed when our businesses are quoted in the market at prices above what we would pay for them*. . . . Valuation plays no role in our sell decisions, and neither do price targets." (emphasis in original).
>
> \- Chris Cerrone, *The Art of (Not) Selling* (December 2019)

We sympathize with both sides of the debate. In theory, an "overvalued" asset should be sold, but, in practice, knowing precisely when that line is crossed is impossible. The "sell if overvalued" proponents believe wrestling with the ambiguity is a worthwhile task. The "never sell due to valuation" proponents believe time is better spent elsewhere, like finding a promising investment.

While we sympathize with both approaches, we are comfortable with neither. The "never sell due to valuation" approach seems too extreme. An investor needs the leeway to sell an asset if its price untethers from its fundamentals. The "sell if overvalued" approach, on the other hand, expects too much of the valuation process. Embracing it fully is likely to lead to harmful overtrading.

We prefer a middle-of-the-road approach. We focus on great companies, and it is important to recognize how rare great companies are. Chances to buy them at fair prices are rarer still. Once in our possession, we ought not sell without a clear reason. Valuation alone provides that level of clarity only if the price is "unreasonable," which is a more demanding standard than "overvalued."

An example may clarify the difference. We originally purchased Apple (AAPL) in 2016 for a split-adjusted price of $26.43 per share. That equated to a cash-adjusted enterprise value of $460 billion. Today, Apple trades around $135 per share, which equates to a cash-adjusted enterprise value of $2.24 trillion. Yet, Apple's cash enterprise earnings are virtually unchanged at roughly $70 billion. Apple's pretax enterprise yield has therefore fallen from ~15% to ~3% (Yields fall as prices rise.).

An investor following the "sell if overvalued" approach may have sold Apple long ago. We have not. Apple may be somewhat "overvalued," but its price does not yet appear "unreasonable." Apple's power is unrivaled in the digital economy, and it is investing record sums into its businesses. Thus, Apple's defensible and likely to grow pretax enterprise yield of 3% appears sensible, albeit not attractive, when compared to the fixed 1% offered by 10-Year Treasury Bonds.

In short, we believe valuation alone can justify selling, but merely being "overvalued" will not suffice for a great company. To be jettisoned for no reason other than valuation, a great company's price must border on the unreasonable. Acting otherwise risks unnecessarily interfering with the process of compounding, and avoiding that mistake is key to ***building permanent wealth***.

Sincerely,

Drew Estes, CFA
Partner & Portfolio Manager

Alek Nabulsi
Partner