BARTON
INVESTMENT MANAGEMENT

CLIENT LETTER NOVEMBER 2007

J. BARTON RILEY, CFA

‘WWPFD’ – When to Sell, or What Would Philip Fisher Do?

In late July, I received more than a few telephone calls from clients, who were worried about the amazing short-term success of their investments in Amazon.com. Their questions revolved around the significant bursts in Amazon’s price after more than two years of insignificant gains and losses in the investment. So, within the context of Amazon’s year-to-date gains, I thought I would write a letter about how to handle success, how to deal with discontinuous price movements and when to sell a the stock of a younger growth-company.

* * *

In order to deal with Amazon.com’s success I must summarize its’ stock price movements since I first began recommending it to some of my clients. According to my records, I first purchased Amazon for clients in September 2004 at prices between $38 and $44 per share. By March 2007, after two and one half years, Amazon’s share price remained almost unchanged; closing the month at just under $40 per share, and yes, most of my clients were questioning why we had invested in this ‘do-nothing’ stock. All of a sudden, in April of this year, Amazon’s share price appreciated more than 50% and closed at $61.33. This sudden price burst led most Amazon holders to think that they had somehow won the lottery, and also to suspect that their rewards would be fleeting. I confess that I, too, was nervous because stock price bursts are unsettling to all of us. However, having seen this before, I repeated the mantra of growth stock investing, ‘properly selected growth stocks are supposed to go up.’

In late July, Amazon’s stock reached $84 per share, and with the stock now up 110% in four months, everyone, including me, was getting a little nervous about the speculative surge in this company’s share price. Recently, after all of the fallout from the crises in mortgage securities markets in August and early September, Amazon’s share price has reached as high as $100 and fallen back to $84. Did we miss the top? Is our success fleeting? As always, the answer lies in reviewing the original premise for the investment, and evaluating what, besides the share price, may have changed.

* * *

Before I go any further, I need to confess. I don’t own any Amazon.com stock in my own portfolio! I sold my holdings in 2005 to partially fund the renovations of our summer home. And, since I enjoy the renovated home very much, I’m not going to beat myself up about missing Amazon's wonderful appreciation. But, in hindsight, I sure wish that I had sold a different holding!

* * *

In brief, the original thesis for investing in Amazon.com was that this company had the potential to become the 'Wal-Mart' of internet retailing. Sam Walton's genius was that he offered his customers 'every day low prices'. One of the great inspirational business books is Walton's autobiography, <u>Sam Walton: Made in America</u>, which was first published in 1993. I didn't read this book until ten years after its release, but I quickly re-learned that there is no more powerful concept in retailing than 'every day low prices'. When I finished Walton's life story, I was prompted to reconsider Amazon.com as an investment.

By 2004, Amazon had matured from its early days when it was the poster child for the Internet stock bubble. For those of you that have forgotten, Amazon's share price rose from its IPO price of $1.50 a share in May 1997 to a high of $113 in late 1999. During this time period Amazon failed to report any profits whatsoever! However, by September 2004, Amazon had matured greatly and it has become a profitable business. After reporting losses for six straight years, Amazon reported a profit of $0.40 per share in 2003, and in early 2005, the company reported that its earnings had doubled to $0.82 per share. Perhaps, like Wal-Mart, Amazon.com was on to something.

But, just when all of us were starting to think the 'lean years' were behind Amazon, its founder and CEO, Jeff Bezos, decided to forego additional profitability in order offer his customers even more value. Amazon offered its customers free shipping on orders of more than $25. Amazon's customers loved this new, lower-cost, opportunity, to buy goods over the Internet. Over the two year period ended in December, 2006, Amazon.com's annual sales more than doubled to $10.7 billion. However, Amazon's shareholders had to watch sullenly as the company's net income declined by 46% to $0.45 per share. Generally, Wall Street and its analysts thought that Bezos and Amazon were 'giving away the store'.

As you might be wondering, what was it that changed? What caused the stock to nearly triple in value? Without advance notice, Amazon has reined in some of their discretionary spending, and their profitability has begun to expand once again. Amazon's pre-tax profit margins last peaked at 9.2% in 2004. In 2006, their pre-tax margin was 4.4%. This year, it is anticipated that Amazon's margins will expand by 30% to 5.8%. When you add the 30% expansion in profitability to an expected growth of 30+% in revenues, 'mirabile dictu', earnings in 2007 are expected to grow by more than 100% to $1.05 per share.

Now we know why Amazon's stock price began its rapid rise in April. The vision that Amazon.com might become a powerful and profitable Internet retailer seems to be coming into greater focus. But, how high is "up"? When should we sell this stock? It can't go "up" forever!

* * *

In 1957, Philip Fisher wrote one of the bibles of investing, <u>Common Stocks and Uncommon Profits</u>. He answered the question of when to sell by stating, "If the job has been correctly done when a common stock is purchased, the time to sell it is- almost never". In order to live with the success of Amazon.com and to define what our sale methodology at Barton

Investment Management is, I have returned to the master and re-read his chapter on "When to Sell". It is amazing how Fisher's words from fifty years ago are still completely applicable today.

According to Fisher, there are only three financial (as opposed to personal) reasons to sell any common stock. The first and most painful reason to sell is "when a mistake has been made in the original purchase". Last November, in one of these letters, I reviewed three under-performing "turkeys" in honor of the Thanksgiving season. That letter was my way of revisiting my original reasons for buying the three stocks and questioning whether I had made a mistake. After I wrote that letter, I began to realize that I had, indeed, made a mistake in purchasing one of the three stocks that I reviewed. Slowly but surely, over the ensuing months, I sold all of the shares of that mistakenly purchased stock at prices that resulted in small losses for most of my clients and myself. Selling this 'mistake' before it festered into a bigger problem was one of my best decisions in the past year. In hindsight, it seems easy, but from all too many experiences, I can attest that it is very difficult to be rational and honest with oneself when admitting to a mistake.

Fisher's second reason for selling a stock is that a once successful and growing company has evolved into something else. Quite tellingly, Fisher uses the verb, "deteriorate", to describe this evolutionary process. There is a life-cycle to most successful companies. They begin as entrepreneurial dreams, they mature into successful enterprises, and when they fail to sustain their advantages, they slowly deteriorate into uninteresting investments. Fisher not only cites the deterioration of a company's business position, but also the possibility of a deterioration of management. In this way, he describes the all-too-normal evolution from a management with an entrepreneurial outlook into a defensive bureaucracy. You can find a lot of good hints in proxy statements and annual reports about whether a management is truly acting in the best interests of their company's shareholders. The deterioration of a great company is most often a slow and steady process. Thus, one generally can take his or her time and sell these investments in an equally slow and steady manner.

The final reason to sell a stock seems obvious; you've found an even better investment. Fisher cautions that most new investment ideas are not as good as your existing holdings. In truth, we know our existing holdings too well, and we often grow impatient with their small imperfections. At the same time, we uncover a new alternate investment that seems shiny and wonderful. According to Fisher, "there is need of the greatest care in trying to appraise accurately all elements of the situation." In other words, don't be a fool and sell your winners too soon, in order to buy an investment that you don't really understand. How do we determine if in fact we have found an even better investment? In my experience, the new idea has to be so compelling that I would willingly take a large position in the stock. If you want to give up on one of your winners, be sure to find a new investment that is worthy of a major commitment.

In the final segment of his chapter on "When to Sell", Philip Fisher criticizes those who might assert that a good growth investment is overpriced. He writes,

> "How can anyone say with even moderate precision just what is overpriced for an outstanding company with an unusually rapid growth rate? … If the growth rate is so good that in another ten years the company might well have quadrupled, is it really of such great concern

> whether at the moment the stock might or might not be 35 per cent overpriced?"

Put differently, there is a false precision to setting a static price target for a dynamic, growing company.

* * *

So, is Amazon.com's stock overpriced? I don't know. I am impressed with the company's success in realizing its vision of offering everyday low prices on a wide variety of products over the Internet. If he were alive today, I don't think Philip Fisher would sell his Amazon stock yet. If you are worried about stocks that are appreciating, remember that they are supposed to! And, if you want some advice on when to sell a great growth company, ask yourself, "What would Philip Fisher do?"

(Please appreciate that because of the significant rise in price of Amazon.com's stock, we are no longer recommending it as a potential purchase for our clients)

The opinions expressed in this Commentary are those of Barton Investment Management, LLC. These views are subject to change at any time based on market and other conditions, and no forecasts can be guaranteed.

The reported numbers enclosed are derived from sources believed to be reliable. However, we cannot guarantee their accuracy. Past performance does not guarantee future results.

A current copy of our ADV Part II is available upon request.