Market Dynamics

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Performance Management System

The Case Of Digital Equipment

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

"That stock is too cheap—it has gone down too much."

A familiar comment I frequently heard from young, inexperienced stockbrokers when I worked for New York brokerage firms.

A collection of recent newsletters is available on the web site.

Please visit my web site at http://www.clayallen.com/

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This is a story of an investment disaster. I worked with a pension fund manager some years ago, who owned a full position in the stock of Digital Equipment (DEC). It must have been in the summer of 1987 and I recommended that he sell the stock that was then trading at about $170 per share because my valuation methods indicated the stock was grossly overvalued. DEC was probably the most popular growth stock of that era and was being recommended by a majority of Wall Street analysts.

My client followed my advice and sold the stock in the high $170's. As I remember, that was a tough time for me as my father died in September 1987 and shortly afterward I had to make a grueling sales trip to New York and Boston. While in New York I visited a well known hedge fund group and the portfolio managers I called on showed a sincere interest in my Value/Price Analysis research service. At the end of my presentation, they asked for my number-one, overvalued, short sale recommendation and I responded with Digital Equipment. They laughed boisterously and said that DEC was their number one long position. That ended the sales call on a sour note and the presentation was abruptly terminated. The institutional salesman who had set up the call was visibly disappointed in my performance and my selection of DEC as a short. Then I set off for Boston. All the institutions I called on in Boston loved DEC and that stuck in my memory.

On my return to Denver, some days later, I learned that my institutional client who had sold DEC, had been ordered by his boss to buy the stock back in the high $180's.

About a month later the market suffered the Crash of 1987. During the Crash, DEC broke $49 per share in one day. I later learned that my institutional client bought more stock at those absolutely, compelling, bargain prices. The fundamentals of DEC's business started to deteriorate and the stock kept going down. As it turned out, my institutional client doubled his position in the stock at about $50 per share. The stock kept going down and I think he bought more at about $30 per share. The stock became a sore subject with my customer and he didn't even want to talk about it

Finally the stock fell into the mid-teens and a dull basing pattern started to form. It didn't go down, but it didn't go up much either. Many times I have watched a crashed growth stock fall into dullness that may last for months or years. It still happens. Finally after a lengthy period, the stock was bought out by Compaq in the mid twenties. I remember that my client had to accept about a $3.5 million loss on the buyout.

This is about the best example of Schumpeter's "creative destruction" I have ever seen. Throughout this period the long-term point and figure charts gave a clear picture of the poor performance of DEC stock. This episode imprinted several important lessons about investing on me. The market always knows more than the individuals on Wall Street. Also, what traded at $100 per share last month, is not necessarily cheap at $50 per share this month

Fundamental investment reports are often nothing more than promotional literature but the long-term charts can tell you what is really going on with a stock.

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