Market Dynamics

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Performance Management System

Now Is Not A Good Time To Chase The Hot Stocks

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

Ignat's Law

An old Wall Street story tells of an individual investor whose speculative stock investments were causing him to lose sleep. His friend was an older man and an accomplished trader and his advice was to

"sell down to the sleeping point."

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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Recent reports of various sentiment measures (advisors bullish, AAII survey, and selling by insiders, to name a few) suggest that investors and market players have become very enthusiastic about stocks. This is a far-cry from the double-dip economic scenario of last summer. The rally that has taken place in the stock market is the strongest rally experienced since 1936. So now what?

It is understood that at some point the stock market will suffer a correction (normal corrections are believed to be a drop of ten percent or less). We don't know the magnitude of any potential correction or whether it would be worthwhile to hedge against an even greater potential decline. It does not seem that holding large amounts of cash is the best answer because we can not reliably estimate the potential downside of a correction. In fact, the upward trend may extend much longer than the pundits have forecast. What should long-term investors do given the expectation of a correction but considerable uncertainty regarding the timing of such a move?

It seems that the bullish enthusiasm has led some investors to jump into the hot stocks that seem to be leading the parade. These are the high relative strength leaders in the market since last August. Some of these stocks have started to jump around from day-to- day but mostly on the upside. Some of these stocks have started to record upside gaps and that is a primary indication that the pot is close to boiling over. Jim Rogers, in his interview in the *Market Wizards* by Jack Schwager, commented that stocks that show upside gaps have become hysterical and therefore should be sold. That seems like good advice right now.

Long-term investors should understand that there are large pools of capital that are actively seeking out shorting opportunities. These aggressive traders tend to search for shorts among the stocks that are the most extended to the upside—the relative strength leaders. When, as, and if, a correction develops, these stocks may get hit the hardest by the activities of aggressive traders shorting the stock. One defensive move that long-term investors should consider is not to chase these high relative strength leaders, and if they are already in the portfolio they should be cut back, perhaps not eliminated from the portfolio, but cut back to no more than an average sized position.

Many institutional portfolios follow a policy of being fully invested at all times. A portfolio can remain fully invested by selecting purchase candidates from the stocks that are showing major bases on the relative strength, point and figure charts and that are still fairly close to the support that formed during the back and forth movements within the base. The base should act as a support zone that has a good chance of holding the stock up during a correction.

In general, highly volatile stocks should be classified as sources of funds for reinvestment in the portfolio. The risk of a stock position should be measured on the relative strength PnF chart from the current level down to likely support at the Bullish Support Line. If the support is too far away, then consider selling the stock. .I have observed that many stocks have more or less exhausted their upside potential when they move 20 rows or more above the BSL. In this way the relative strength PnF charts become a risk management tool.

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