

## How To Produce Better Investment Performance?

**Portfolios heavy with under-performing stocks almost never outperform the market. Ignat's Law**

**Why should an investor believe that he knows more than the market?**

**He usually doesn't!**

[A](#) collection of recent newsletters is available on the web site.

**Market Dynamics**

[www.clayallen.com](http://www.clayallen.com)

7325 S. Jackson St.  
Centennial, CO 80122

Phone: 303-804-0507

[clayallen@msn.com](mailto:clayallen@msn.com)

The answer to these questions seems to be remarkably simple and yet the academic community can't see what is right in front of their noses. For an investor seeking better investment performance, individual or professional, the answer is the same. Don't hold stocks that perform poorly and only hold stocks that perform well. The logic of this simple proposition seems to be undeniable.

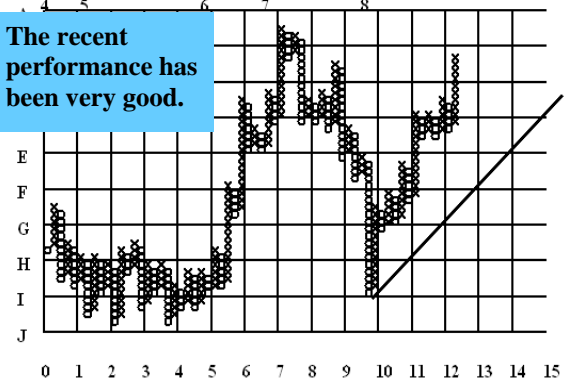
The real answer seems to lie in the mechanics of how you determine whether a stock is performing well or performing poorly. The academics are correct when they describe the market as being partially random in nature but that randomness is the smallest part of the movement for most stocks. The randomness lies in the day-to-day fluctuations of a stock price which are usually minor in nature and often cancel themselves out. Randomness in no way precludes a trend in a stock price and the magnitude and persistence of the trend is what is important to investors seeking better performance.

Experience shows that some stocks may follow a path that produces a proportion of 55% of the days to the upside and 45% of the days to the downside. Experience also shows that such a stock may produce price changes on the up days that are substantially bigger than on the down days. This characterizes a stock with a strong up trend. More days up than down and the up days are bigger than the down days. This produces a major long-term up trend and participating in stocks with strong up trends produces good performance. This bias in the price produces a trend that can lead to exceptional returns from investing in that stock.

Does the investor know how long this trend might last? Usually not. If the investor measures the trend of the stock with a chart he can determine when the up trend ceases and a down trend takes

MARKET DYNAMICS - RELATIVE STRENGTH (2.5% box) vs S&P 500  
BIG LOTS INC 05/02/2008 28.31 BIG

The recent performance has been very good.



over. Until the up trend stops or loses its strength, it is best for the investor to maintain his position in the stock. This is not a matter of prediction, as much as it is a matter of the measurement of the trend. It is very simple. The trend will continue until it stops and when the good performance stops, the investor has a strong indication that the performance of the stock has become unacceptable and he should make a switch.

Why should the money manager think that he knows something about a stock that the market doesn't know, just because he knows a few facts about the company from its financial statements or its history or that he has talked with the management of the company? He bought the stock to produce good investment performance and whether he is right or not depends on how the stock behaves in the market. The stock's performance in the market is not accidental and it is the result of large numbers of individual decisions to buy and sell. A portion of the market price fluctuations for a stock may be random but the trend is not often wrong.

To believe that the market is wrong is to rationalize a way to hold a stock that is performing poorly. For a portfolio manager to believe that he knows more than the market is just pure arrogance. Holding stocks that perform well is the best route to better investment performance.

W. Clay Allen CFA