Market Dynamics

Managing For Better Performance

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Performance Management System

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

"You cannot manage what you do not measure."

Peter Drucker

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Better investment performance is a widely sought after goal, and yet, it has proven to be elusive for many professional investment managers. It seems that the answer to the question of how to achieve better investment performance is so obvious that it is often overlooked.

There are many, many reasons why stocks are purchased for a portfolio. It should be understood that the decision to buy a stock is nothing more than a hypothesis (i.e. a guess) about its future performance in the market. The buyer must believe that for some reason the stock will outperform the market or it shouldn't be added to the portfolio. Even if the decision to purchase the stock is based on highly specialized knowledge about a company, the stock is not relieved of its responsibility to outperform the market.

It makes no difference how the decision to buy the stock was made. If the objective is better performance by the portfolio, then the stock's continued retention in the portfolio should be totally dependent on its ability to fulfill its promise of good performance without regard to how the stock was selected for purchase in the first place.

This implies that the portfolio manager must be able to measure the performance of the individual stocks in the portfolio. There are two sources of variation by a stock's price that don't contribute to the measurements of a stock's true trend of performance. The random day-to-day variation in every stock's price must be removed by the measurement process. In addition, the measurement process should remove the influence of the fluctuations of the overall market and this is usually done through the use of a technique called relative strength..

The portfolio manager must also be able to distinguish between acceptable performance and unacceptable performance by each stock. This implies that the portfolio manager should develop a set of rules to determine what is acceptable performance and what is not acceptable. It is also important to account for short-term periods of under-performance that must be tolerated as the stock fluctuates back and forth in the market. It is the major, long-term, persistent trends of performance that determine whether a stock should continue to be retained in the portfolio.

The three box, point and figure charting technique using relative strength is the perfect tool for measuring the long-term performance of a stock. The influence of the market is removed and the short term random fluctuations are damped out by the three box filter. The intermediate term fluctuations show up as alternating columns of Xs (representing performance that is better than the market) and Os (representing performance that is worse than the market). The alignment of the extremes of these columns of Xs and Os provide a fairly objective measure of the trend of performance.

Higher highs and higher lows represent good or acceptable performance by the stock. Lower highs and lower lows indicate unacceptable performance by the stock. A pattern of horizontal highs and horizontal lows indicates a trading range but that is also an indication of unacceptable performance by the stock because it is only matching the performance of the market, not producing overperformance.

Stocks with a pattern of higher highs and higher lows are contributing positive alpha to the performance of the portfolio. Stocks with lower highs and lower lows are detracting from the performance of the portfolio by generating negative alpha.

It should be obvious that every stock in the portfolio has a job to do and that job is to outperform the market. In order to improve the performance of the portfolio it is necessary for the portfolio manager to record and measure performance to tell which stocks are getting the job done and which aren't.

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