Market Dynamics

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Performance Management System

Why Do Most Institutional Portfolios Under-perform?

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

"You cannot manage what you do not measure."

Peter Drucker

The reason most institutional stock portfolios under-perform the overall market is because they hold too many stocks for too long that under-perform the overall market. This appears to be self-evident and does not need an elaborate academic explanation. I call this Ignat's Law.

Most academic textbooks about long-term stock investing offer the Efficient Market Hypothesis as the explanation for why institutionally managed stock portfolios under-perform. Belief in the Efficient Market Hypothesis requires the acceptance of ideas that do not hold up in the real world. The answer to why institutional stock portfolios under-perform is right under most academic's noses and yet they refuse to see it.

Most institutional investors have been convinced not to use stock charts for any purpose. And yet, stock charts are an essential tool for measuring the performance of individual stocks. Charts of a stock's relative performance should be used to measure the performance of the stocks in the portfolio not to predict future performance.

The portfolio manager does not need to predict future performance, he needs to measure the recent performance of the stock. If that performance is bad that is all that is required to know. The reasons for the bad performance may be difficult or impossible to determine. However, the bad performance is not an accident and the reasons for the bad performance will come out sooner or later. If the performance measurement is focused on the long-term trend of performance and the trend is bad, the portfolio manager should believe that the trend of bad performance will probably continue and it will negatively impact the performance of the portfolio.

Sometimes, persistently bad market performance by a stock is actually an indication of serious problems, maybe even criminal activity, within that company. In recent years, many institutional investors have been misled by company managements and analysts regarding the true financial performance of a company. Some companies have actually been engaged in fraud and misrepresentation of their accounting statements. Either way, fraud or just bad business judgment by company management, the bad performance by the stock provided meaningful indications that something was not right.

A decision to buy a stock is essentially based on a belief that the stock will perform better than the market. This is also an hypothesis and will be proven or denied by the future performance of the stock in the market. It is necessary to measure the performance of each stock to verify that the factors that led to the purchase are producing the desired outcome. These measurements are best accomplished by using a long-term chart of the stock's relative performance. It must remembered that this does not produce a prediction of future performance other than to say that if the long-term performance is bad, it will probably continue and that is undesirable.

Portfolio managers are usually aggressively indoctrinated into the belief that charts cannot predict the future performance of a stock, therefore charts are completely worthless. This completely overlooks the primary use of charts to measure the long-term performance of a stock. It seems simple enough, if the performance is bad, don't hold it hoping it will turn around, it probably won't. Portfolio managers who measure performance won't even consider buying more of a stock with bad performance. Why compound a mistake? Get rid of the mistake, don't add to the problem.

Learning to chart a stock's performance is usually an education received in the "college of hard knocks." and not in some academic program. All portfolio managers need to learn how to measure performance so they can improve the performance of their portfolios.

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