Market Dynamics

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Performance Management System

The Simple Truth About Bad Performance

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

"The really serious losses come where someone closes his mind and stubbornly refuses to recognize new factors in the situation."

The General Semantics of Wall Street
By
John Magee

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http://www.clayallen.com/

Market Dynamics
7325 S. Jackson St.
Centennial, Colorado

Phone: 303-804-0507

clayallen@msn.com

The simple fact is that bad investment performance is caused by portfolio managers holding too many stocks with bad performance for too long. This simple truth should be self-evident.

The cause of bad performance does not require advanced mathematical statistics to understand. It does not need a ridiculous theoretical explanation such as the "Efficient Market Hypothesis" to explain why bad performance is so widespread. It seems irrational for so many investors to behave this way and yet they do.

Why investors hold so many stocks with bad performance is a much better question. Is it the result of self delusion or stubbornness that causes investors to hold bad stocks? The answer to this question should help explain how investors can achieve better investment performance.

The answer to the question of bad performance seems to have two parts. First, investors have a built in bias to buy stocks that are down in price. Second, very few investors measure the performance of the stocks they hold and therefore are unaware of their bad performance.

The urge to buy bargains leads to a widespread tendency to buy stocks that are not only down in price but they are still going down. Investors seem to be preprogrammed to buy stocks with bad performance and the bad performance almost always continues. This seems to be a quirk of human behavior and it appears to be ubiquitous. Investors would be much better off if they waited for the stock to stop going down. When a stock gets to be too cheap it will stop going down. Until it stops going down, the investor must assume that it is not too cheap.

The second part of the answer to bad performance is the fact that many, if not most, portfolio managers do not systematically measure the performance of the stocks they own. This can be traced back to the academic proposition that stock price movements are random and charts are worthless.

The most effective way to measure performance is with a long term chart of the stocks performance but stock charts are considered taboo for any purpose by most investment professionals. The purpose of stock charting is not to predict what the stock will do in the future but to measure how it is performing now. The presumption is that the performance shown on the chart, good or bad, will probably continue. The long-term point and figure charting methodology is perfect for such measurements.

Experience shows that long-term trends of relative performance do persist for many stocks. It is also true that when the trend of performance stops or reverses direction it can be seen on the charts.

There seems to be little doubt that stock price movements are random and unpredictable. The lack of predictability makes the use of stock charts indispensable to investors, especially long-term investors. How else will you know when the performance goes from good to bad? The academic community seems to be quite confident of their condemnation of stock charts but they can't offer an effective alternative to managing for better investment performance.

W. Clay Allen CFA