Market Dynamics

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Performance Management System

The Activity That Most Portfolio Managers Neglect

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

"If you measure it, it will improve."

Purple Cow

by

Seth Godin

There is one aspect of investment portfolio management that is often neglected and it leads to poor performance. The portfolio manager needs to measure the performance of every stock in the portfolio and act accordingly. Stocks with bad performance should be sold and stocks with good performance should be retained in the portfolio.

It seems self-evident that there is only one cause of poor investment performance. Too many stocks with bad performance are held in the portfolio for too long.

This is primarily due to the fact that many portfolio managers do not systematically measure the performance of the stocks in their portfolios. They are unaware of how bad the relative performance of many stocks can be and that bad performance can persist for long periods of time.

It should be understood that stocks with bad performance behave randomly. It is also true that stocks with good performance behave randomly as well. Randomness does not explain the relative performance of a stock. Good performance by a stock is not accidental and bad performance by a stock is not accidental either. Good performance is evidence that the stock did not follow a random walk. The same is true for stocks with bad performance.

Randomness suggests that you cannot predict the future performance of a stock but that is not to say that you can't measure that performance. If the performance by a stock is good it can be retained in the portfolio for as long as the good performance persists. Conversely, stocks with bad performance should be eliminated from the portfolio.

This is the most important activity of portfolio management and yet it is not carried out by the majority of portfolio managers. Most portfolio managers seem to believe that successful portfolio management is solely a function of stock selection and good stock selection will automatically generate good investment performance. There is no allowance for mistakes in the stock selection process and yet experience shows that investment mistakes are inevitable. This is the real fact about the randomness of stock price movements. The lack of predictability makes investment mistakes inevitable but many portfolio managers behave as if their stock selection process is foolproof.

Portfolio managers need to plan for these investment mistakes and be able to identify them as soon as possible. The identification of investment mistakes depends upon measuring the performance of every stock in the portfolio and acting accordingly.

Research in the field of behavioral finance suggests that many portfolio managers follow an opposite course because they don't measure performance. They tend to sell the stocks with good performance and retain and buy more of the stocks with bad performance. It should not surprise anyone that selling the winners and holding the losers results in bad overall performance. A simple record of a stock's performance in the market is a good defense against such a counter-productive management style.
W. Clay Allen CFA

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