Market Dynamics

Volume 8, Issue I40

October 23, 2009

Performance Management System

A Faulty Assumption About Investing

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

"Businessmen play a mixed game of skill and chance."

John M. Keynes

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Most academic instruction about investing in stocks rests on the faulty assumption that you must be able to predict the stock prices to be able to make money in stocks. This assumption is almost never questioned by the teachers or the students. On more careful examination this assumption proves to be false.

While it is true that if you could predict the future of the stock price, you could make money investing in stocks. But the inverse is not true, i.e. that if you can't predict the future of the stock price that you can't make money in stocks.

Making money in stocks is the result of participating in stocks that go up and that participation does not have to be based on a prediction. The decision to buy a stock, to participate in a stock as an investment, should not be based on a prediction. If fact, since predictions are so often wrong, it is unwise to base an investment program on predictions.

Many successful investors select stocks to buy based on the stock's established trend of performance and the idea is to maintain that participation for as long as the stock's performance remains satisfactory. This in no way requires a prediction.

The investor does not make any prediction, whatsoever, about how long the good performance will last. In fact, sophisticated investors know that the trend of good performance will not last forever and that the good performance must stop at some point. The decision to maintain the participation in the stock rests on the continued good performance by the stock.

In order to determine whether the performance is satisfactory or not, the investor must measure the performance of every stock in the portfolio. The question now becomes how to effectively measure the performance of individual stocks, not how to predict that performance.

The measurement process can be set up in such a way as to minimize the effects of random, meaningless stock price movements and let the significant long-term price trend show through. Another source of meaningless variation in stock prices is the movement of the overall stock market as a whole. Relative strength can be used to remove the effects on an individual stock that are the result of the fluctuations of the stock market as a whole. This lets the investor measure the price movements that are specific to that individual stock.

The academic community's concentration on the randomness of stock price movements has created the false belief by many investors that stock price movements are unimportant and nothing could be further from the truth. Stock price movements may be random but they are certainly not unimportant. Stock price movements, especially long-term persistent trends should be used to decide which stocks to buy and then to determine how long to maintain the participation in that stock.

Most academic instruction in investing includes aggressive indoctrination into a belief that stock prices cannot be predicted, but later the instruction shifts into the study of how to predict future stock performance using the analysis of the company fundamentals. It seems more effective to accept the notion that the measurement of performance provides the most critical input to the process of successful stock investing.

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