Market Dynamics

A Good Offense AND A Good Defense

Volume 8, Issue I45

November 27, 2009

Performance Management System

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

Ignat's Law

Investing is a lot like basketball, the players have to play both good offense and good defense to win the game.

A collection of recent newsletters is available on the web site.

Please visit the web site at http://www.clayallen.com/

Market Dynamics
7325 S. Jackson St.
Centennial, Colorado

Phone: 303-804-0507

clayallen@msn.com

Many investors approach the problem of portfolio management with "one hand tied behind their back." They believe that if they perform the buy decision properly that's all they need to do. They assume that if they buy their stocks right, then the selling will take care of itself. Nothing could be further from the truth!

Investment mistakes are an inevitable part of portfolio management. Your buy decisions can never be perfect. There will always be problem stocks that don't work out. You need a good defense to know when and what to sell. In one case, you need to know when to take profits on a successful investment. In the other case, you need to be able to identify those investments that are not working out as hoped and to sell to limit the downside before it becomes serious. The sell decision, the mainstay of a good defense, is often completely overlooked by many, if not most, investors.

It is very common for investors to sell too soon. To eliminate a strong stock from the portfolio just to capture the profit is usually a mistake. This is borne out by research in the field of behavioral finance. The investor should hold his winners for as long as he can to maximize the profit. To sell without a good reason, other than to take the profit, reduces the performance of the portfolio.

It is also very common for investors to hold poorly performing stocks far too long. The bad performance is there for all to see and yet the stock is retained in the portfolio. It seems that there is often a psychological commitment to a stock that makes recognizing a mistake even more difficult. This is the situation that many investors refuse to acknowledge and it often has a very negative impact on the performance of the portfolio. Some investors completely refuse to believe the poor performance and are willing to buy more of stocks that are going down—usually a big mistake.

How can these problems be corrected? Experience shows that the sell decision is best formulated using technical analysis. It is a long-term chart of the stock's relative performance that should drive the sell decision. The long-term chart should damp out the noise in the price data and remove the influence of the overall market. This reveals the performance of the stock that is specific to that company. This approach removes the investor's reliance on the sales activity and promotional literature from Wall Street.

This is a very important function in portfolio management and the investor should perform these duties on his own. The long-term chart is not used to predict the future, but to reveal the long-term trend of performance. The academic community shuns the use of charts and many investors do not ever grasp the importance of using long-term charts to play good defense. This is a very serious shortcoming in the training of many investors.

In investment research, as in scientific research, the best answers come from the best questions. The long-term charts help provide the right questions at the right time. For example, if this stock is so great, why is it going down?

W. Clay Allen CFA