Market Dynamics

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Performance Management System

The 80/20 Rule For Stocks

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

"Stocks going in the wrong direction are the wrong stocks to be in."

Burton Crane

Long-time financial editor for the New York Times

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The 80/20 rule indicates that in many situations the actions of a significant few of the inputs, about 20%, will produce 80% of the results. This rule is called the Pareto Principle and experience shows that it applies in the stock market.

In portfolio management, it is often invoked to explain how the best 20% of the stocks in a diversified portfolio will produce 80% of the portfolio return. It is also equally important to consider that the worst 20% of the portfolio will produce 80% of the losses or under-performance. This is a very practical rule and it is encountered in almost all types of markets.

It seems that the primary reason for the significant minority of the stocks in the portfolio to produce a very large proportion of the overall return is due to the fact that the magnitude of the standard deviation of returns from stocks is so very large relative to the average return.

In a recent statistical test for a very large sample of stocks yielded an average of +14% and a standard deviation of 36. The mean plus 1/2 a standard deviation produced a return of 32%. The normal distribution usually allows for almost 30% of the sample to lie 1/2 a standard deviation above the mean. This is the far right side of the distribution of returns and, in this example, the best 30% of the stocks showed returns that were more than twice the return of the average stock.

This clearly defines where the best opportunities are found for long-term investors. It is important to make sure that the portfolio of stocks is mostly positioned in the righthand extreme of the distribution. It also indicates that the portfolio should avoid those stocks in the left side of the distribution because they will produce returns that are significantly below the average return for all stocks. The stocks in the middle of the distribution will produce returns close to the average, so if the objective is to generate excess returns above the average return, the stocks in the middle of the distribution are of little interest.

How does the portfolio manager make sure that the stocks in the portfolio are mostly positioned in the right side of the distribution of returns? The procedure is to record the relative performance of every stock on a chart. Stocks that are moving out into to the far right, positive side of the distribution of returns will show a very strong upward trend on the relative strength charts. There is no requirement for the chart to be predictive in anyway. As long as the trend of relative performance is upward the stock is suitable for retention in the portfolio.

This measurement process on the charts makes use of a 45-degree line that slopes upward to the right from a prominent low on the relative performance chart.. This is most useful on charts that are constructed according to the point and figure methodology for recording relative strength. The PnF methodology makes use of a filter that removes the minor, day-to-day squiggles on the charts and focuses the portfolio manager on the long-term trend. It is natural for stocks to experience minor or secondary movements back and forth as the overall market fluctuates up and down. The secondary trends are shown as alternating columns of Xs (for movements up) and Os (for movements down) on the PnF charts. It is the alignment of the tops of the columns of Xs and the bottoms of the columns of Os that determines the long-term trend. A pattern of higher highs and higher lows on these alternating columns of Xs and Os will produce a long-term up trend.

If the portfolio manager's objective is to outperform a major market average such as the S&P 500, these charts of the trend of the relative returns will clearly show which stocks should be retained in the portfolio and which stocks should be avoided. These trends are hard to misinterpret on the long-term charts of relative strength and they provide a systematic and proven approach to investing for better performance.

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