

## A Compass and A Speedometer

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

**A compass and a  
speedometer do not  
predict where the vehicle  
will go.  
But they are extremely  
important instruments to  
help the driver arrive  
safely at his intended  
destination.**

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

[http://  
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All stock investors need a financial compass and a stock speedometer. Most investors know where they want to go but they need instruments to tell them if they are headed in the right direction and how fast they are moving. The point and figure charts of relative strength effectively combine the features of a compass and a speedometer.

The financial weather and the currents in the stock market are always unpredictable and sometimes they can blow the investor far off course or completely swamp his vessel. It is extremely important for the investor to know his direction of travel. It would be completely foolish for an investor to set off on a financial voyage without the proper navigational instruments and yet that is exactly what the academic community advises investors to do.

Every investor wants to do better than the market and the PnF charts of relative strength tell him whether he is going up or down relative to the market. They also tell him how fast he is moving in that direction.

If the investor is doing better than the market the PnF chart of relative strength will move upward to the right. If he is doing worse than the market, the chart will move downward to the right. The three-box minimum size for a reversal acts like a filter to remove the meaningless, random movement from the chart. Therefore the chart faithfully shows the direction of movement as the market fluctuates over time. Only the significant movements show up on the chart.

Not only does the chart show the direction of movement relative to the market, but the slope of the relative strength plot indicates how fast the stock is moving in that direction. Stocks that are moving up strongly in the market will

show a very steep slope upward to the right. Stocks that performing very poorly relative to the market will show a sharp rate of decline on the chart.

Some stocks, approximately one third of all stocks, will show little sustained movement in either direction. Their patterns on the charts will follow a horizontal path back and forth with little net progress relative to the market. These stocks are trading range stocks and they need to be avoided by investors seeking to outperform the market.

There is one thing that is constant about the stock market. It will fluctuate continuously. Keynes described this back and forth movement as "alternating waves of optimism and pessimism." To facilitate the observations of these alternating waves of movement, the PnF charts record those intermediate trends as alternating columns of movement on the chart. An intermediate up trend will be recorded as a column of Xs on the chart that will extend until a downward wave sets in and reaches a certain minimum amount. When this minimum size is reached, the chart moves ahead one column and that new downward trend is then recorded as a column of Os. That downtrend will be recorded until a new minimum sized up wave appears and the chart moves forward one column into a new column of Xs.

These alternating waves of Xs and Os are not recorded as a function of time, but as the result of the fluctuations of the stock up and down relative to the market. The number of alternating columns that appear as the chart moves across the page is actually a result of the stock's volatility. This means that the chart measures the direction and speed relative to the stocks volatility. Since volatility is considered to be a proxy for risk, the charts actually measure the relative return versus the risk. This is a relationship that is very important to every investor. Is the investor being adequately compensated for taking the risk of owning that stock? The movements on the chart will provide the answer to that question, yes or no.  
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