Market Dynamics

Volume 9, Issue I4

January 23, 2010

Performance Management System

You Cannot Make Money In A Stock By Yourself

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

Ignat's Law

It is revealing to consider the idea that the buyer of a stock will share the experience of the other recent buyers of the stock. If the other buyers are winning, then you might win as well if you buy the stock. Conversely, if the other buyers are losing, then you will probably lose if you buy the stock.

Many investors use the excuse that they are long-term investors and that they are "in it for the long-term." Short speculative movements in the market for a stock can be safely ignored. This overlooks a very rich source of information about whether the trend favors a long-term position or not. When the long-term fundamentals are positive, it is highly likely that the stock will be going up. If the stock is still going down, the trends of the long-term fundamentals are probably questionable. There are usually very good reasons why the other buyers are having a bad experience.

Many investors demonstrate a desire to buy stocks that are going down because they are too cheap. This leads the investor to buy stocks where the other buyers are losing money. If the investor understood that he will probably share their losing experience he might not be so willing to buy stocks in confirmed downtrends. Experience shows that when a stock does get to be too cheap, it will stop going down as knowledgeable investors start to buy the stock. While the stock is still going down, the investor can have little confidence in an opinion that the stock is too cheap.

This simple observation about sharing the experience of the other recent buyers of the stock could save many investors from almost sure losses.

Just because the other buyers have been making money in the stock is no guarantee that the buyer will win in that stock as well. It is the nature of a random process that it is unpredictable and that it can change direction at any time. This makes continuing observations of the trend essential for the long-term buyer of the stock. He needs to verify that the other buyers are still making money and this is confirmed by a continuation of the positive trend as shown on a long-term relative strength chart.

The point in time when the other buyers start to lose in a meaningful way is key to a successful investment in a stock. The investor must continue to observe whether this is a short-term blip on the chart or a genuine long-term reversal of the major trend.

The long-term investor does not want to be shaken out of a good stock by a meaningless blip on the chart. Long-term point and figure charts of relative strength are constructed in such a way as to emphasize the long-term trend in the performance of the stock. Stocks whose performance becomes unacceptable on these charts should not be ignored. In this way, problem stocks are identified and removed from the portfolio before the damage becomes unmanageable. Investors who understand that they will share the experience of the other recent buyers are in a stronger position to act when the trend turns down. As long as the other buyers are recording a positive experience in the stock, the stock deserves to be retained in the portfolio. This helps avoid the premature sale of good stocks and the winners are held until that experience turns negative.

W. Clay Allen CFA

Stocks whose performance becomes unacceptable on these charts should not be ignored regardless of whether the investor is long-term oriented or not.

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