Market Dynamics

Volume 9, Issue I6

February 5, 2010

Performance Management System

Every Stock In The Portfolio Must Earn Its Keep

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

Ignat's Law

The essay "Manage the portfolio like a business" can be viewed on my web site at http://www.clayallen.com/investing.htm

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

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

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Every stock in the portfolio is like a worker in a business, it has to produce positive results or the business will suffer. This is a basic concept of portfolio management and yet many professionals neglect to follow this simple technique for determining whether the stock should be retained in the portfolio or replaced.

The fundamental idea is that the investor is running the risk of owning the stock and he should be compensated for running that risk. Many professional portfolios contain stocks that are clearly not rewarding the manager and they detract from the performance of the portfolio. Since most professional managers are graded on the performance of their portfolios, it would seem that they should be more sensitive to the performance of the individual stocks in the portfolio.

It would make sense to establish rules that determine whether a stock is retained in the portfolio and that should be a function of the stock's market performance. Poorly performing stocks in the portfolio degrade the performance of the portfolio and they will result in a poor evaluation for the portfolio manager. This certainly will not benefit the investors in the portfolio and may put the portfolio manager's career at risk. This seems to be a very simple problem to correct for professional investment managers.

The portfolio manager needs to accept the principle that the stock's performance in the market is what determines its suitability for retention in the portfolio. Once this idea is embraced, the only problem is how to measure the stock's performance.

Long-term investors should not be driven by the day-to-day action of the stock in the market. It is the longer-term trend of performance that counts. The longer-term trend will probably evolve from a random process but that is not to say that the resulting trend of performance is accidental. The longer-term trend is a function of the accumulation of many days of short-term price movements. It goes without saying that successful long-term investors know that the long-term trend of performance reflects the dollar-weighted opinions of the majority of investor's expectations about the future performance of the company. The trend may develop randomly but it is not meaningless.

The academic community would have us believe that because stock price movements are random, and therefore unpredictable, that the trends of performance are meaningless. Tell that to the shareholders of ENRON or any of the more recent investment disasters in the bear market of 2008. Many of these stocks had clearly fallen into long-term downtrends long before the sub-prime mortgage crisis swept over the market. The historical evidence is clear, long-term trends of performance provide a very useful insight into the future performance of a stock. Some managers delude themselves and their customers into believing that the trend of performance can be safely ignored. What folly!

Many case studies of the performance of a large number of highly popular stocks over the past five years prove the validity of this concept. These case studies can be viewed on the "case histories" tab of my web site at www.clayallen.com. The past five years have proven to be an ideal workshop to test and verify these ideas.

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