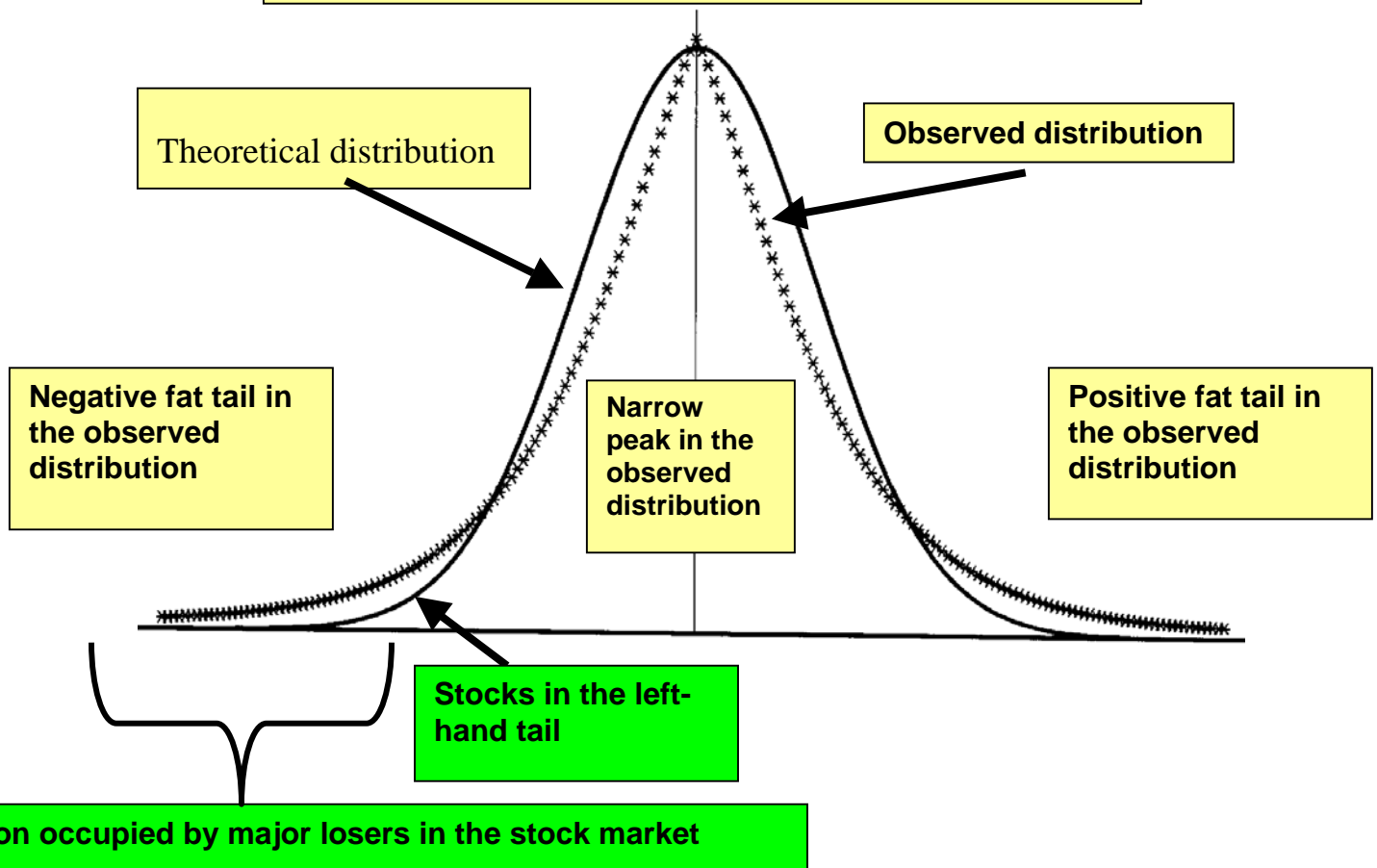


How to avoid the big losers in the stock market.

Major losers are stocks in the left-hand tail of the distribution of returns

Left-hand tail – worst 15% to 20% of all stocks – 80/20 rule works – 80% of portfolio losses come from the worst 20% of the stocks.

Distribution of returns – Normal vs. Fat Tails

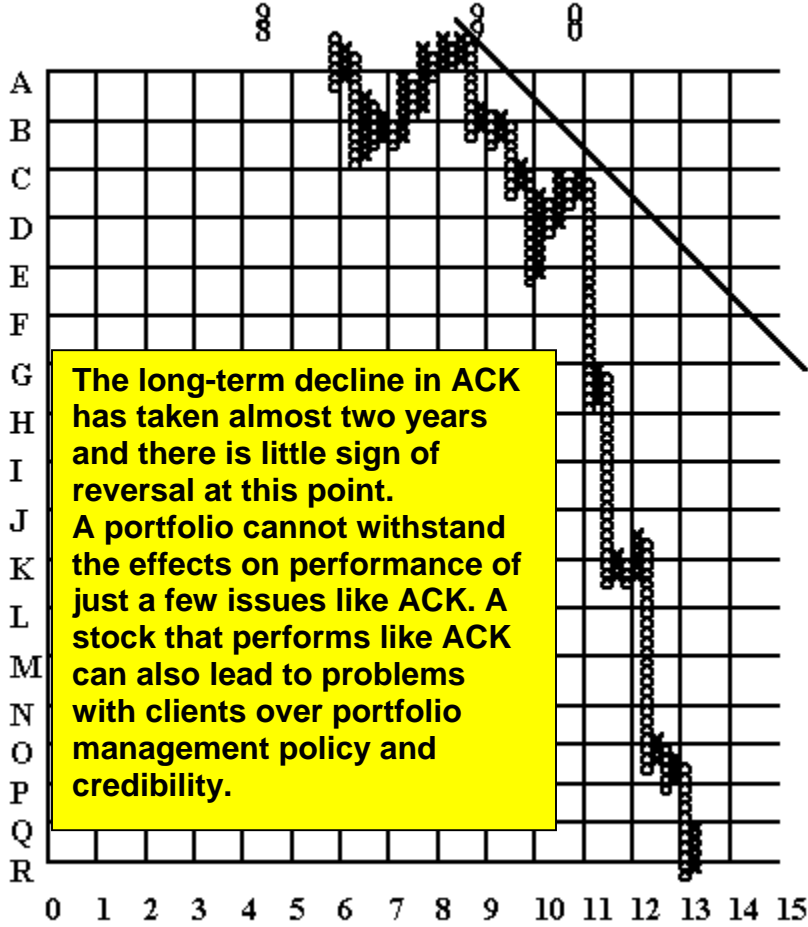


The far left tail of the distribution of returns is the region of major losers.

Damage control is a major factor in successful portfolio management. Most institutional portfolios are fully invested at all times so a process of continually upgrading the portfolio is required. As soon as a stock can be identified as a non-performer it should be sold and the proceeds switched into a stock with more potential. Losers are often held far too long and performance suffers as a result. This upgrading process assures that the portfolio adapts to change in a positive way. Stocks that are too cheap to sell hurt the portfolio twice – they underperform and they occupy a slot in the portfolio that could be invested in a winner.

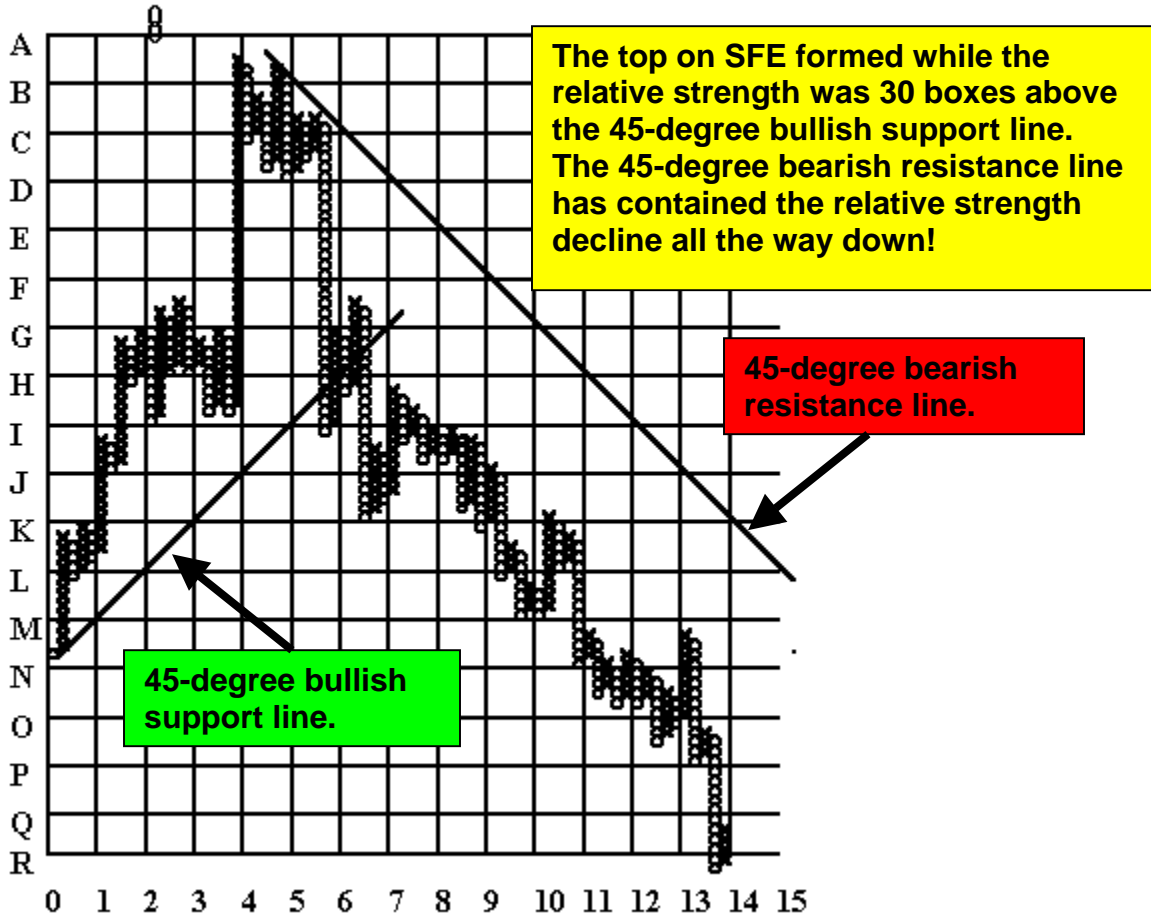
Experience shows that it often takes a long time for a loser to turn around.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
ARMSTRONG HOLDINGS INC 12/22/2000 2.25 ACK



When bullish predictions fail – the litmus test is derived from the market action – don't wait for fundamental confirmation – sell stocks that break down – more often than not, stock prices lead the news – believe what you see.

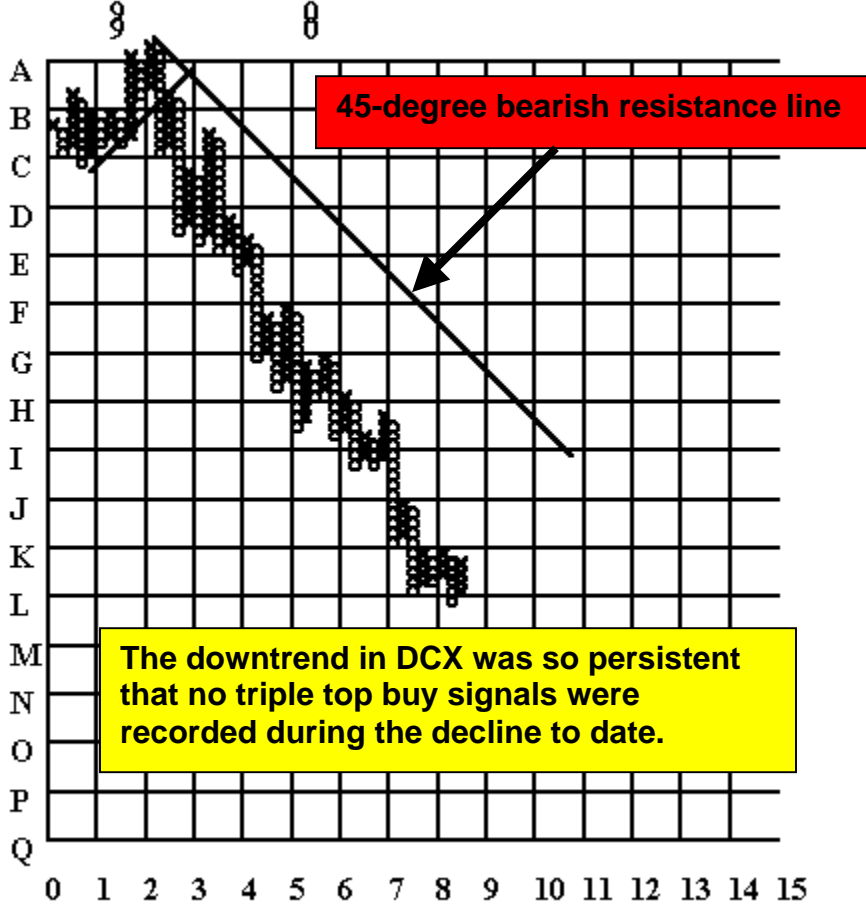
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
 SAFEGUARD SCIENTIFIC INC 12/22/2000 6.5 SFE



-Degree

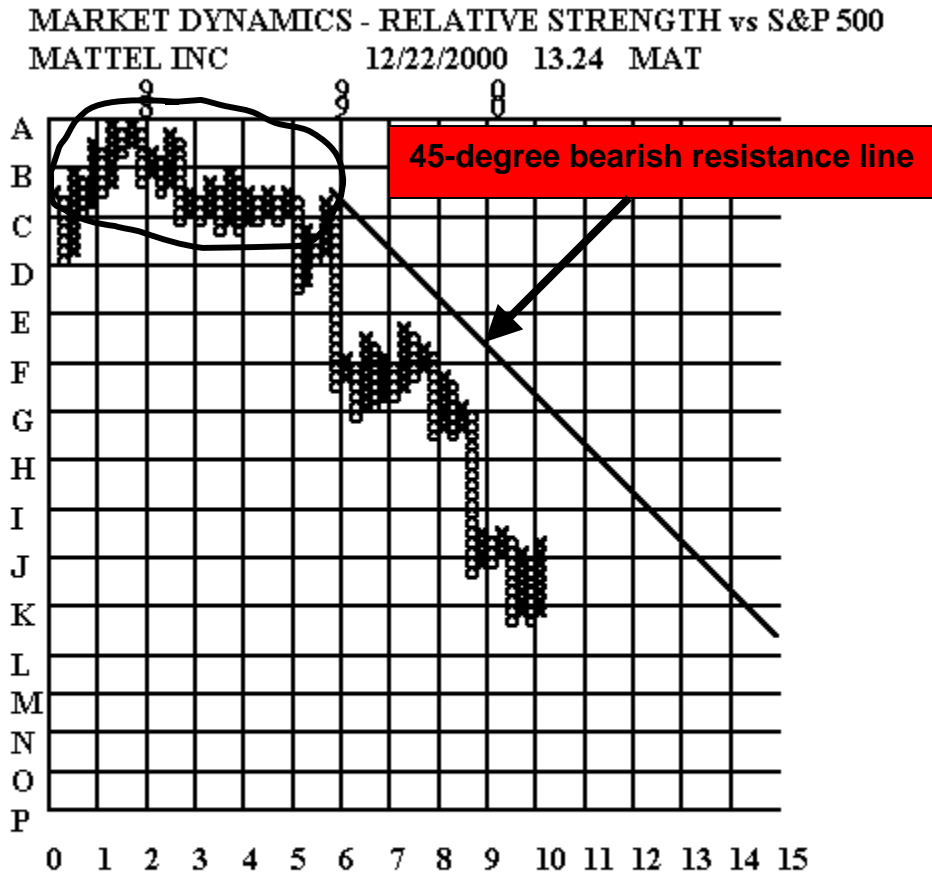
Avoid bargain hunting – stocks going down are the wrong stocks to own.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
DAIMLERCHRYSLER AG 12/22/2000 40.38 DCX



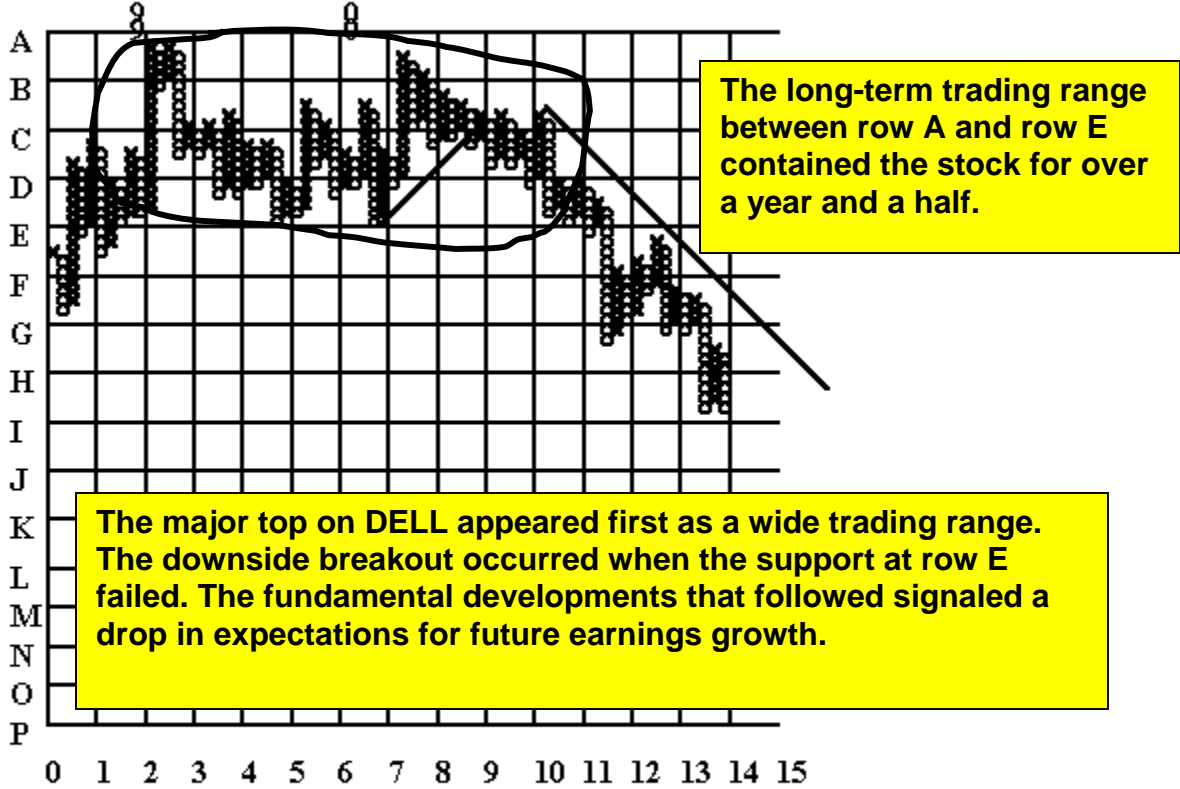
Two patterns that usually precede major losers

Pattern #1 – Stocks that break down from major trading ranges.



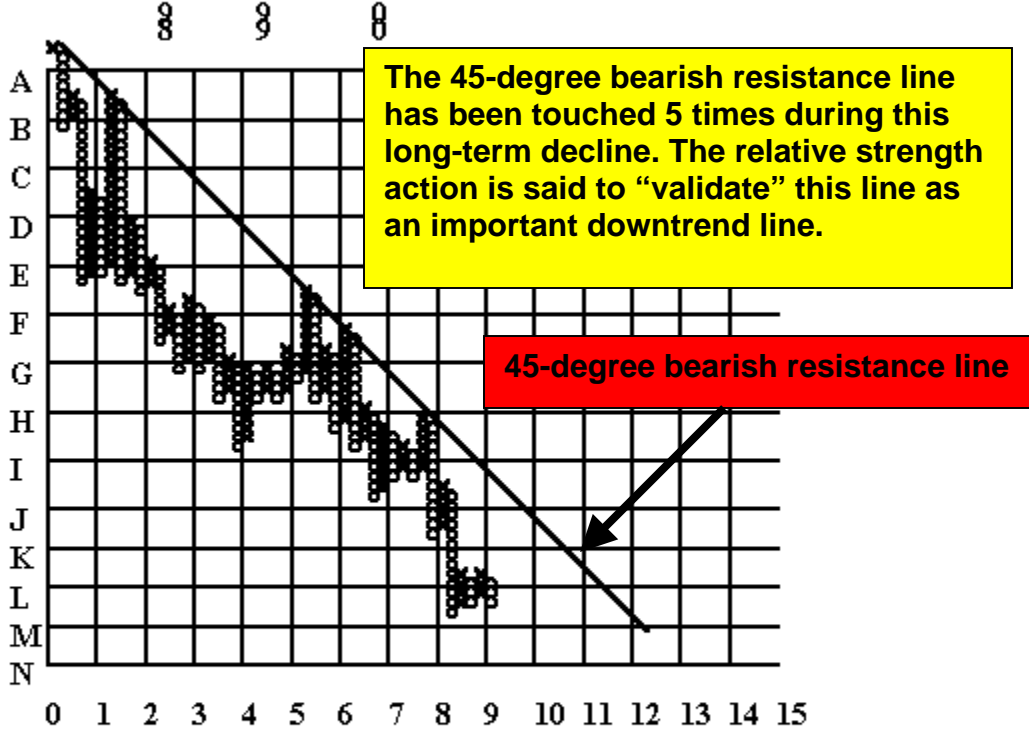
Primarily a problem for "GARP" / value managers

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
DELL COMPUTER CORP 12/22/2000 18.38 DELL



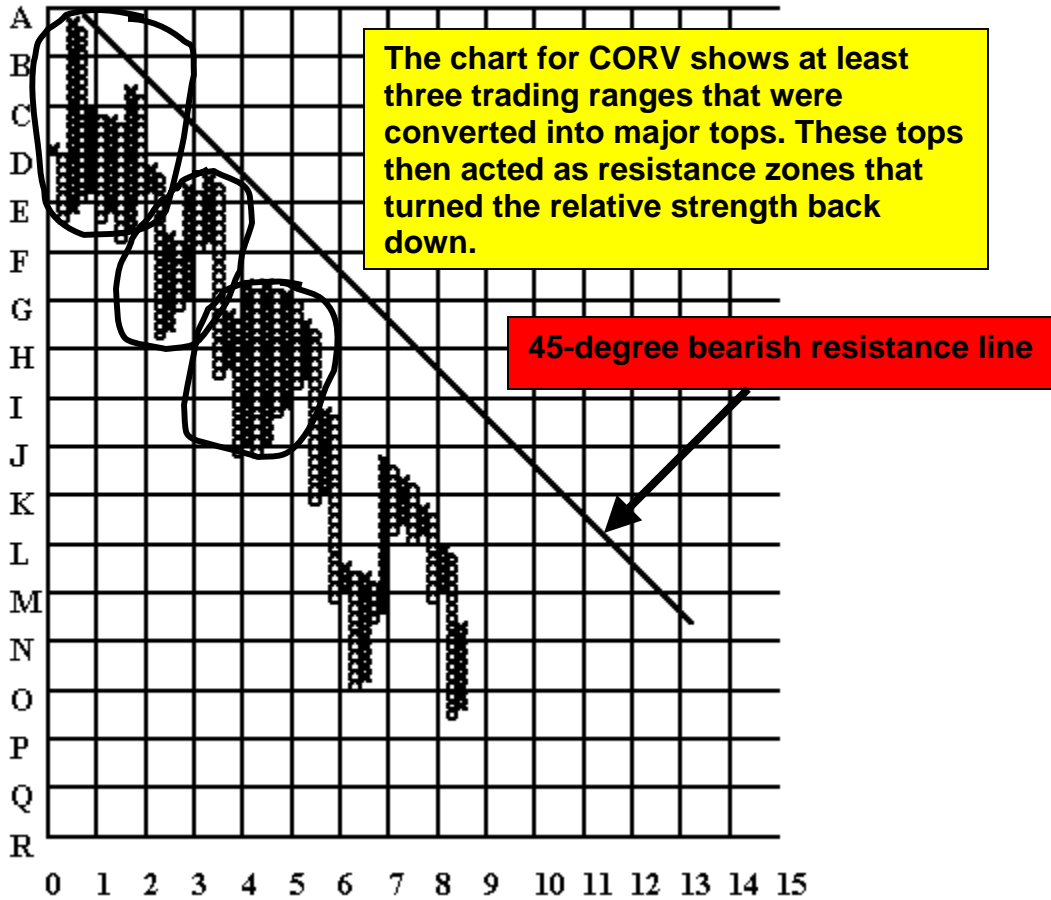
Usually stocks with long-term fundamental deterioration.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
SILICON GRAPHICS INC 12/22/2000 3.63 SGI



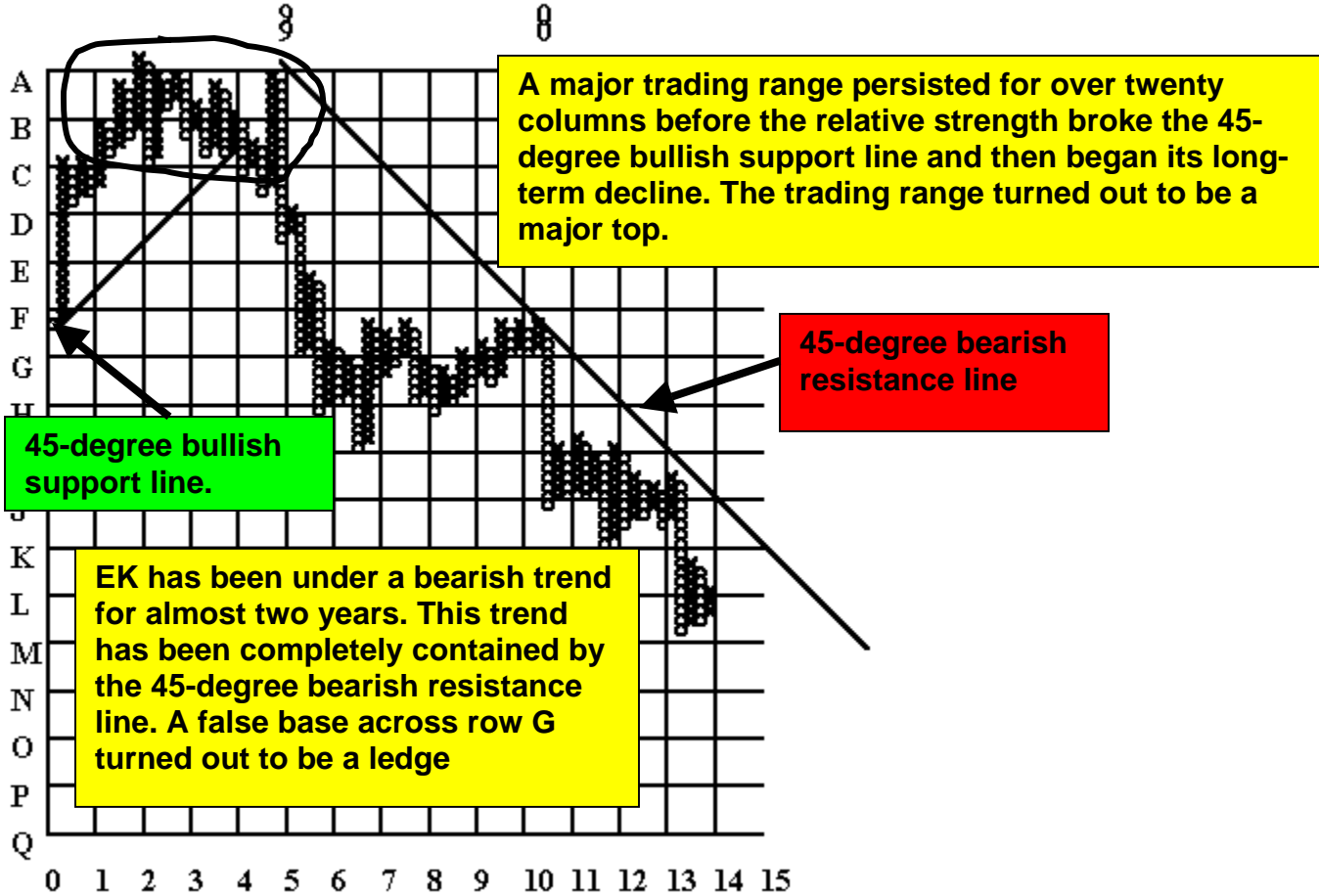
Trading range develops into a major top that represents solid resistance against future price rises.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
CORVIS CORPORATIONNN 12/22/2000 21.63 CORV



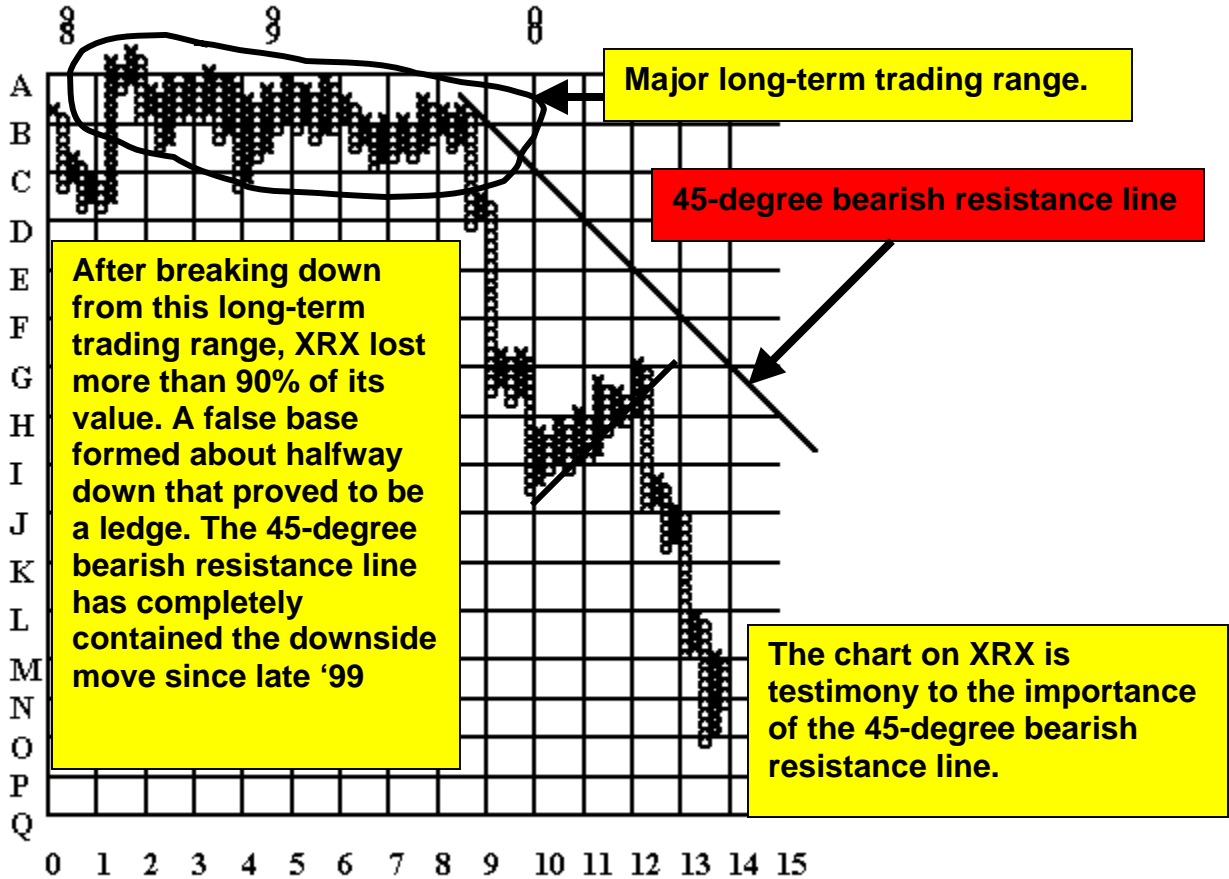
Mature company's stocks that go into long-term financial deterioration.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
 EASTMAN KODAK CO 12/22/2000 38.88 EK

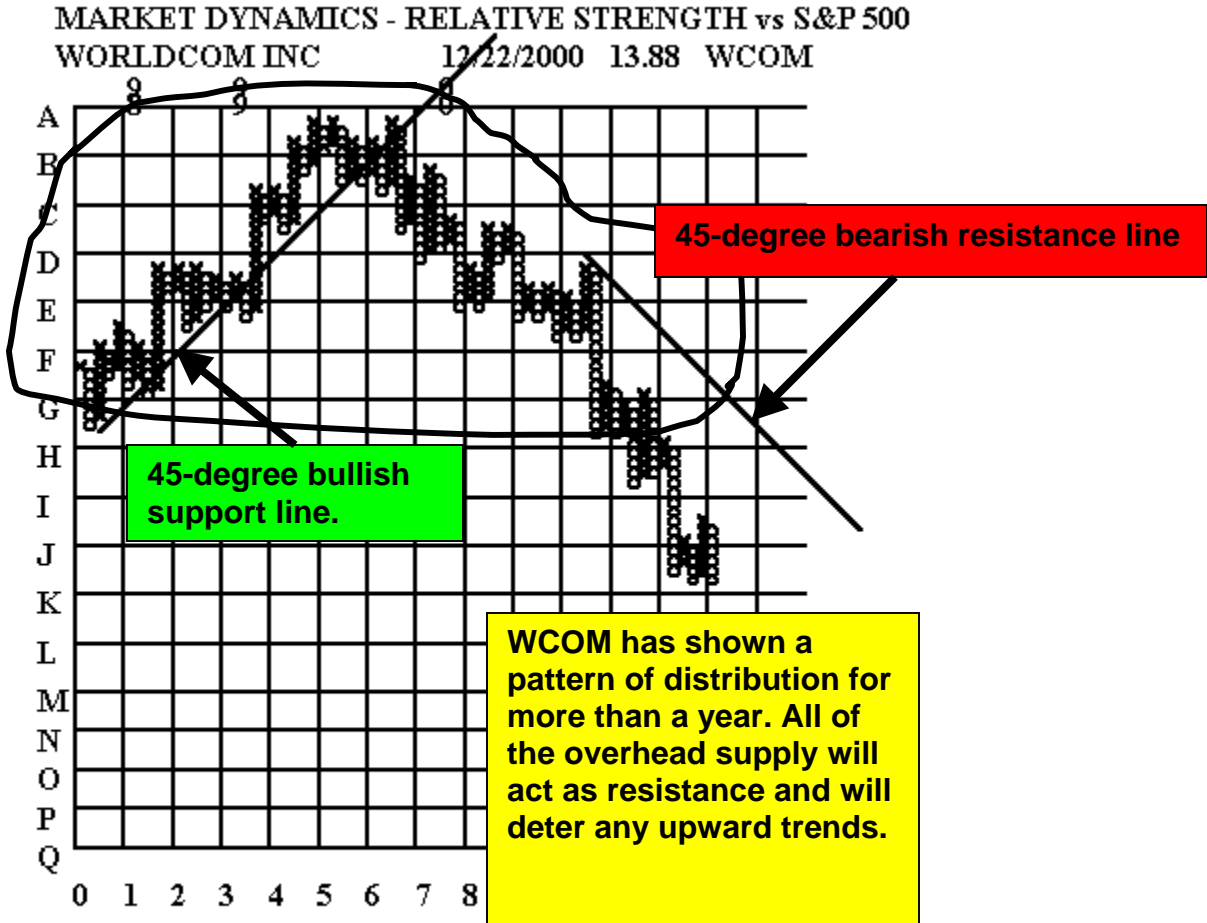


The danger of “bottom fishing” – incomplete basing patterns – negative surprises.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
XEROX CORP 12/22/2000 5.06 XRX

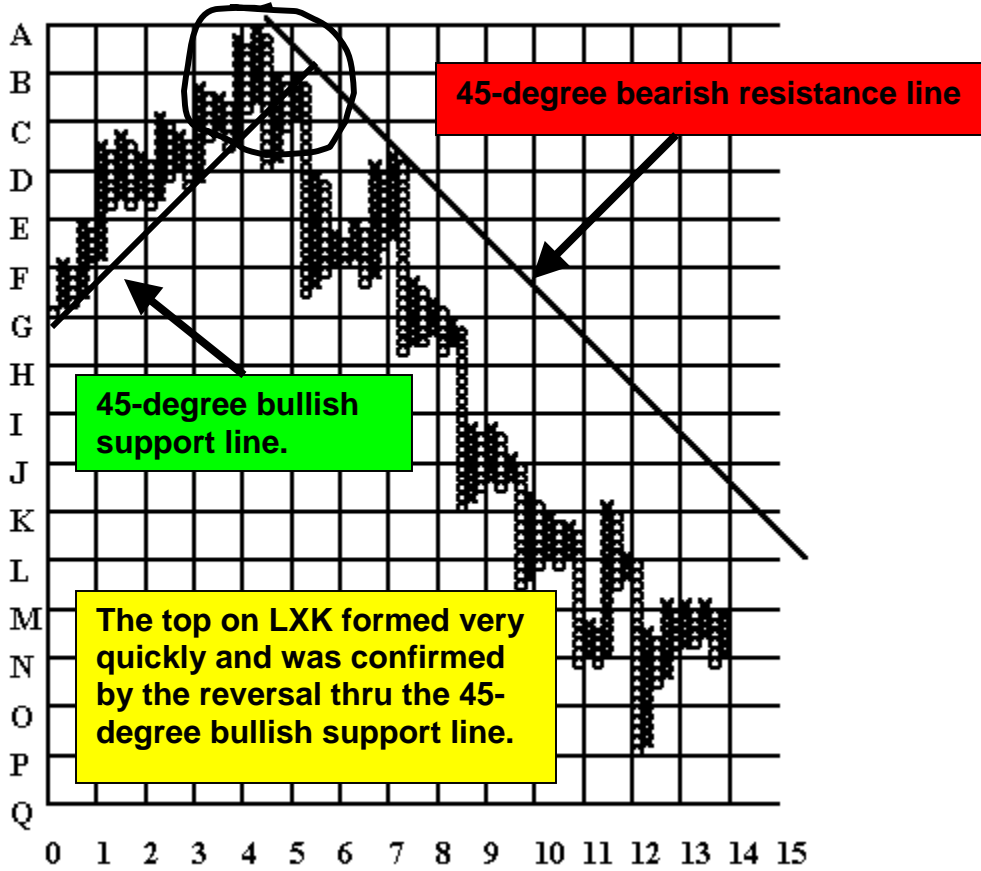


Avoid stocks that show long-term distribution.



Pattern #2 -Speculative stocks that break down / collapse

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
LEXMARK INTERNATIONAL 12/22/2000 44.94 L XK



#2 Primarily a problem for momentum / growth managers

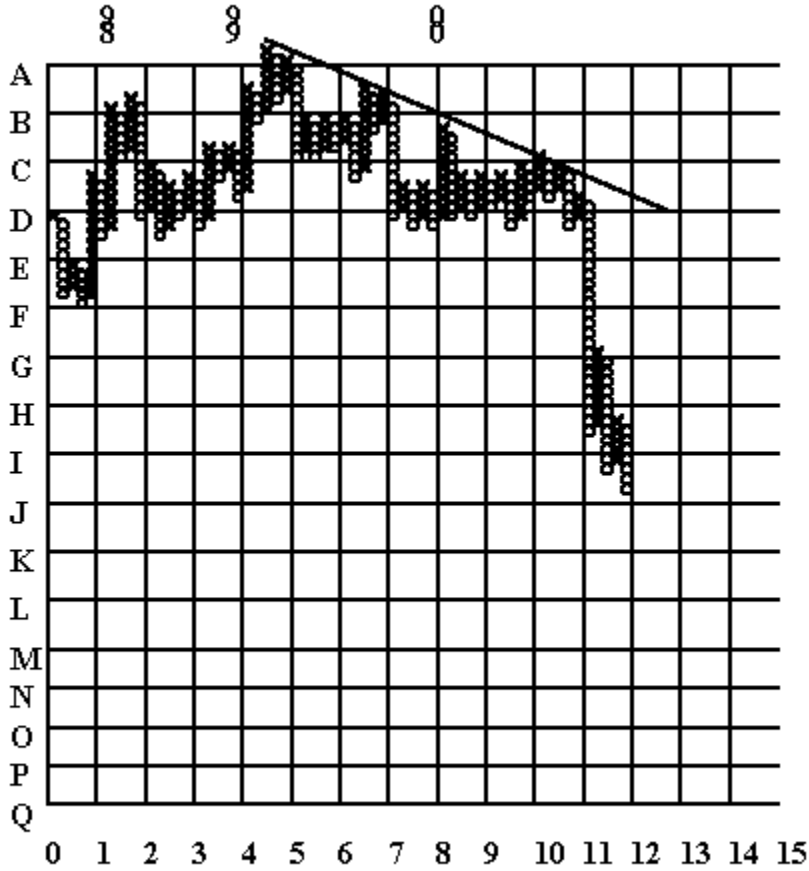
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
CMGI INC 12/22/2000 6.88 CMGI



Earnings disappointments – dramatic psychology reversal.

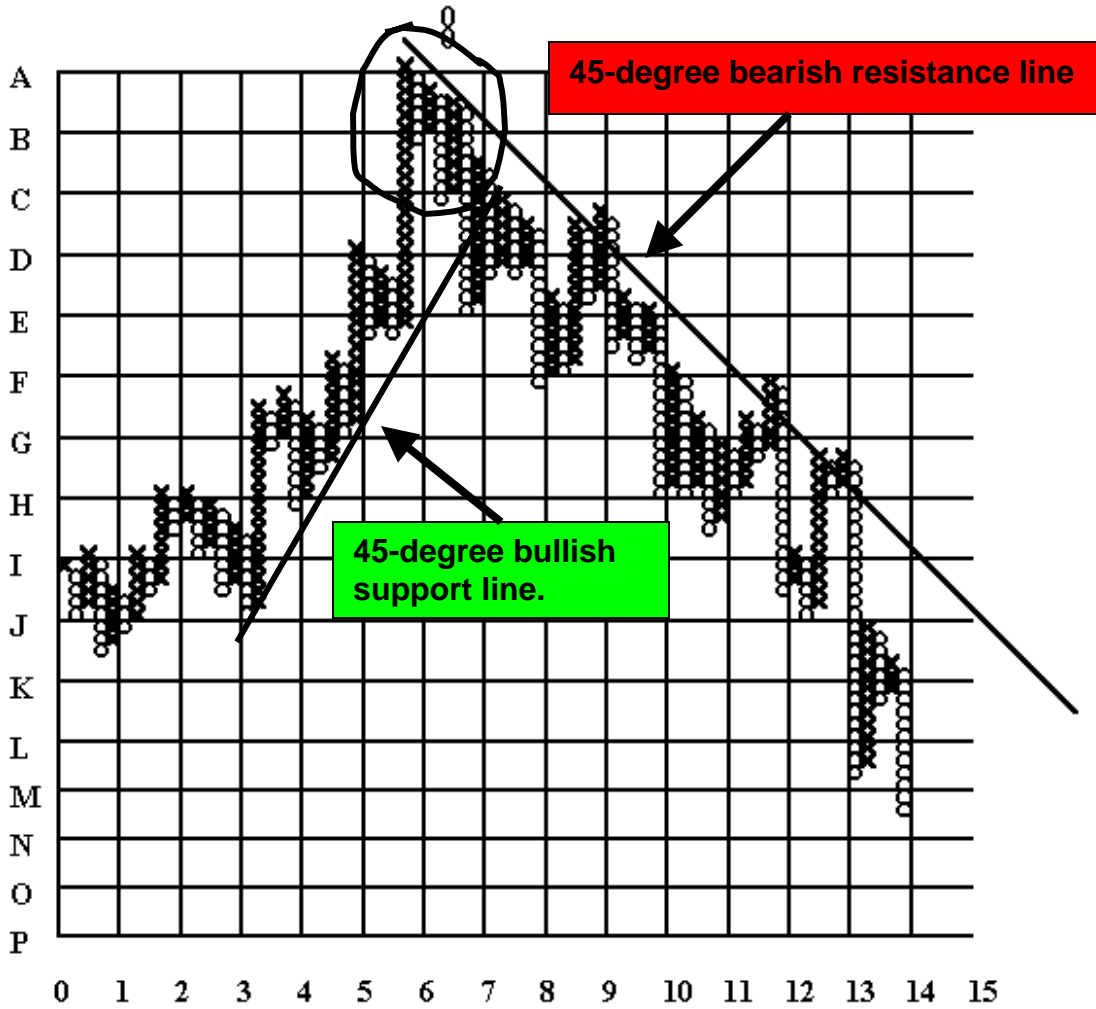
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500

AT&T CORP 12/22/2000 17.81 T



Rapid reversal from up to down – often does not show a major top –
downside usually much faster than the upside.

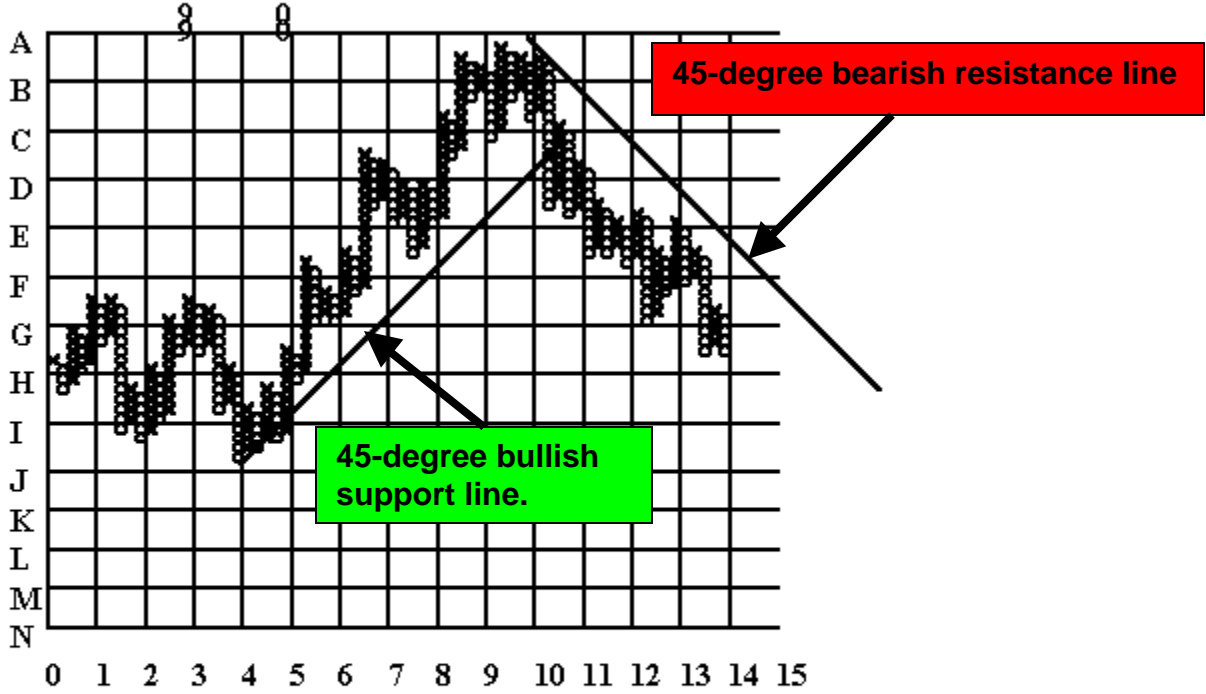
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
BRIO TECHNOLOGY INC 11/29/2000 5.38 BRIO



Prior bull move suggests magnitude of risk.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500

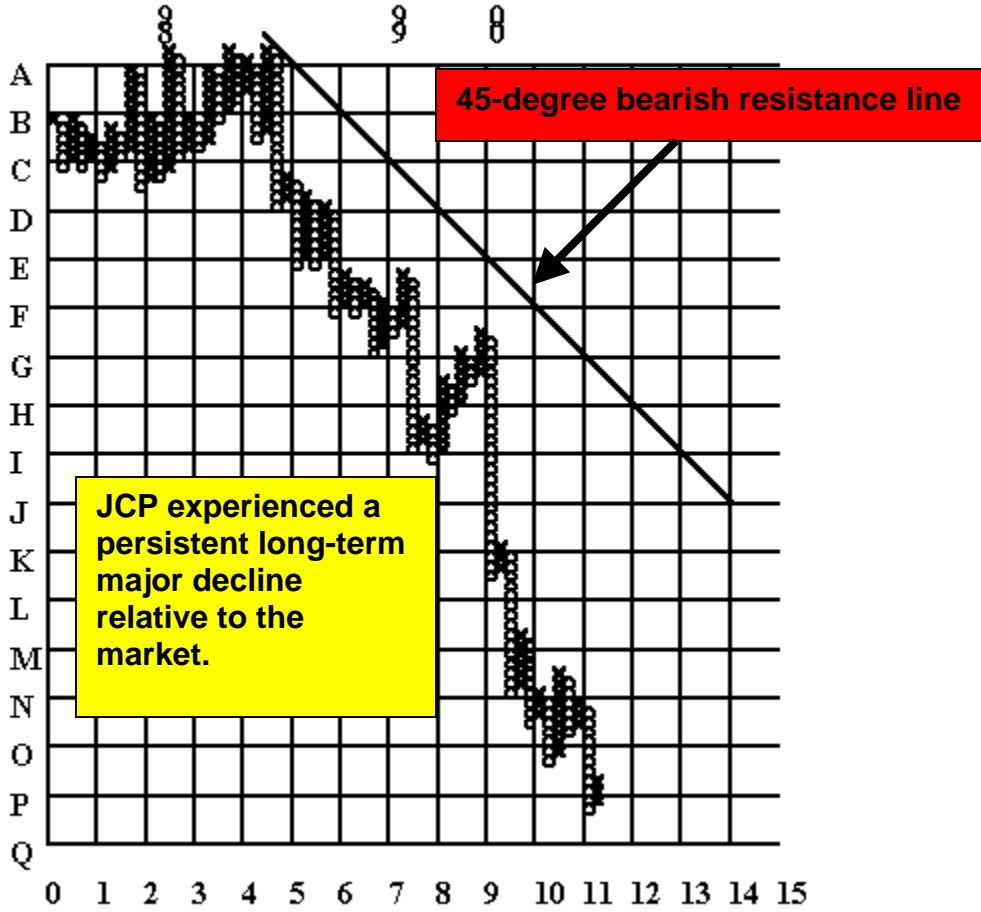
ADVANCED MICRO DEVICES 12/22/2000 14.31 AMD



Major risk associated with “bottom fishing”

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500

J.C. PENNEY COMPANY INC 12/22/2000 9.19 JCP



45-degree bearish resistance line is critical in avoiding premature purchase.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
OWENS-CORNING FIBERGLAS 12/22/2000 .88 OWC



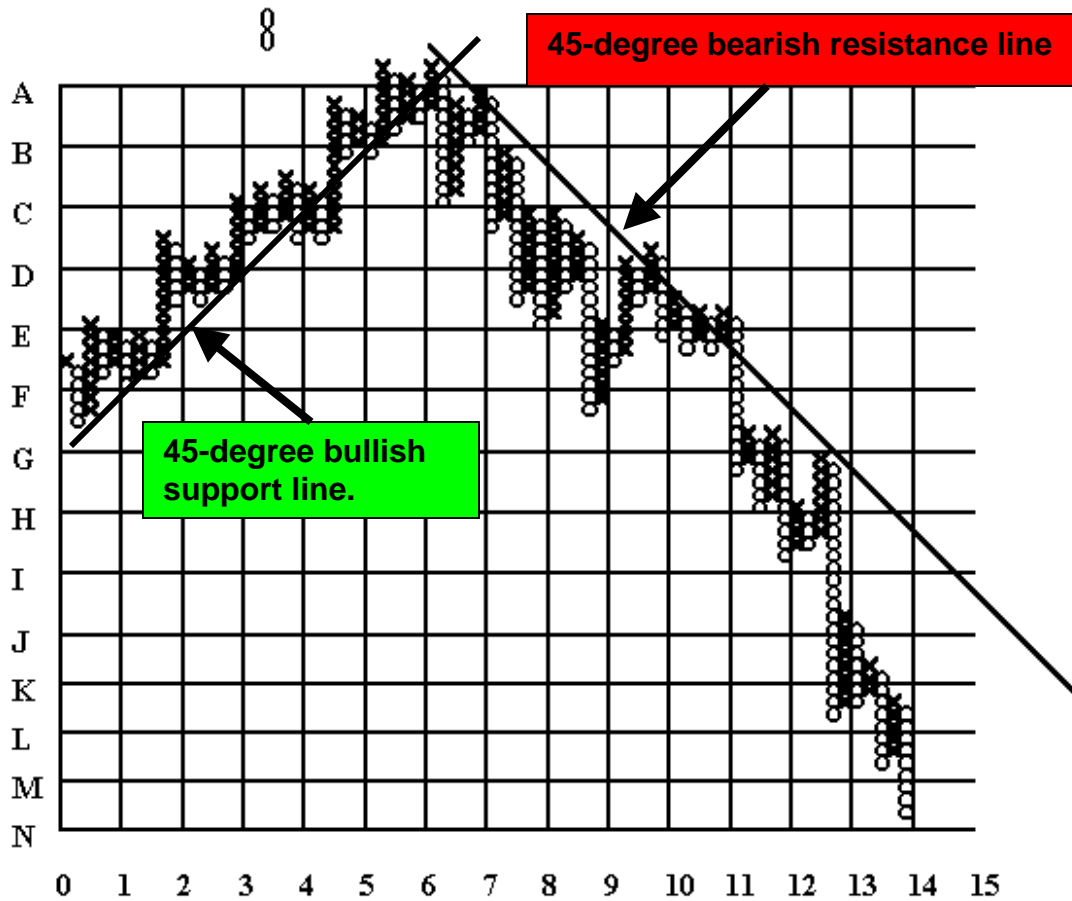
Ledges – false bases and downside breakouts – stop outs

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
PROFIT RECOVERY GP INTL 12/29/2000 6.38 PRGX



Losers hurt performance in two ways

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
PRIMUS TELECOM GROUP 12/29/2000 2.31 PRTL



Losers are defined by their failure to perform.

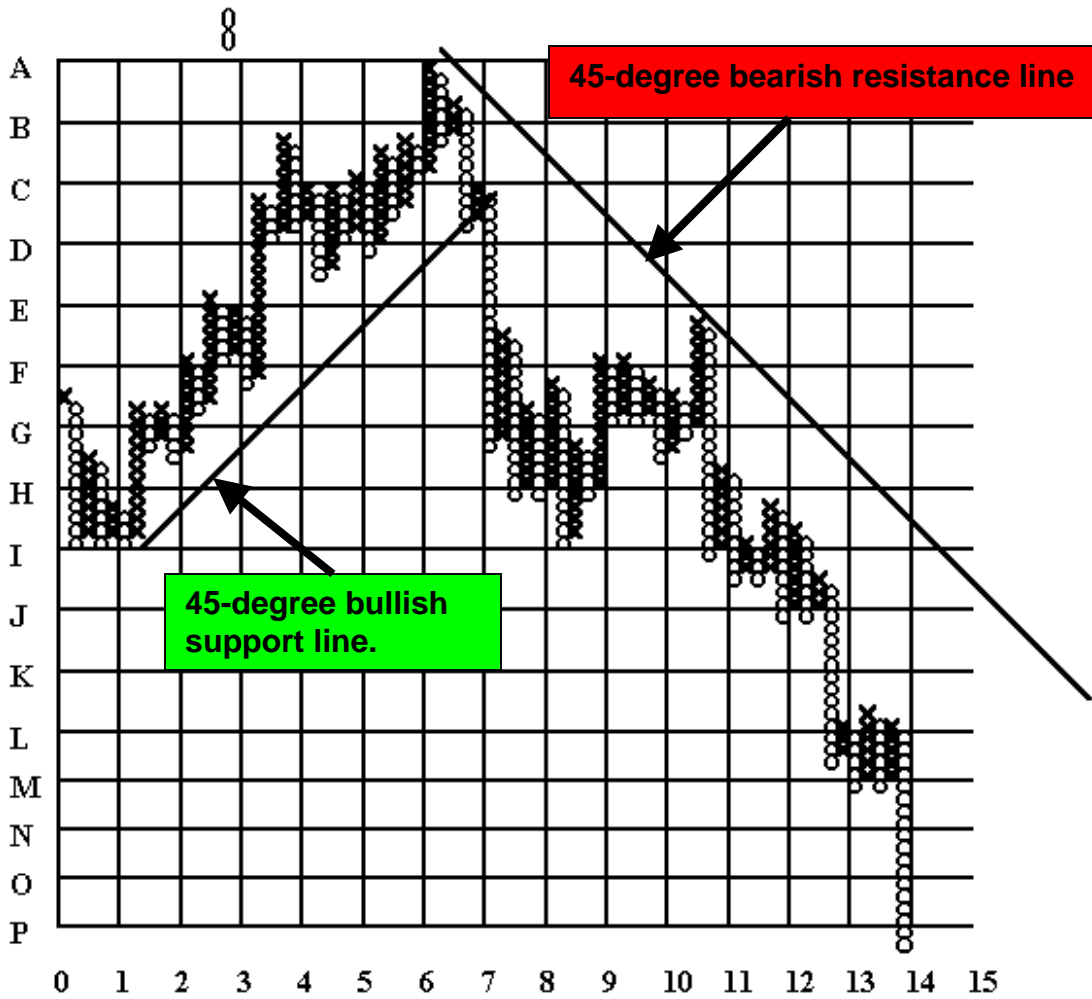
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500

PLUG POWER INC 12/29/2000 14.69 PLUG



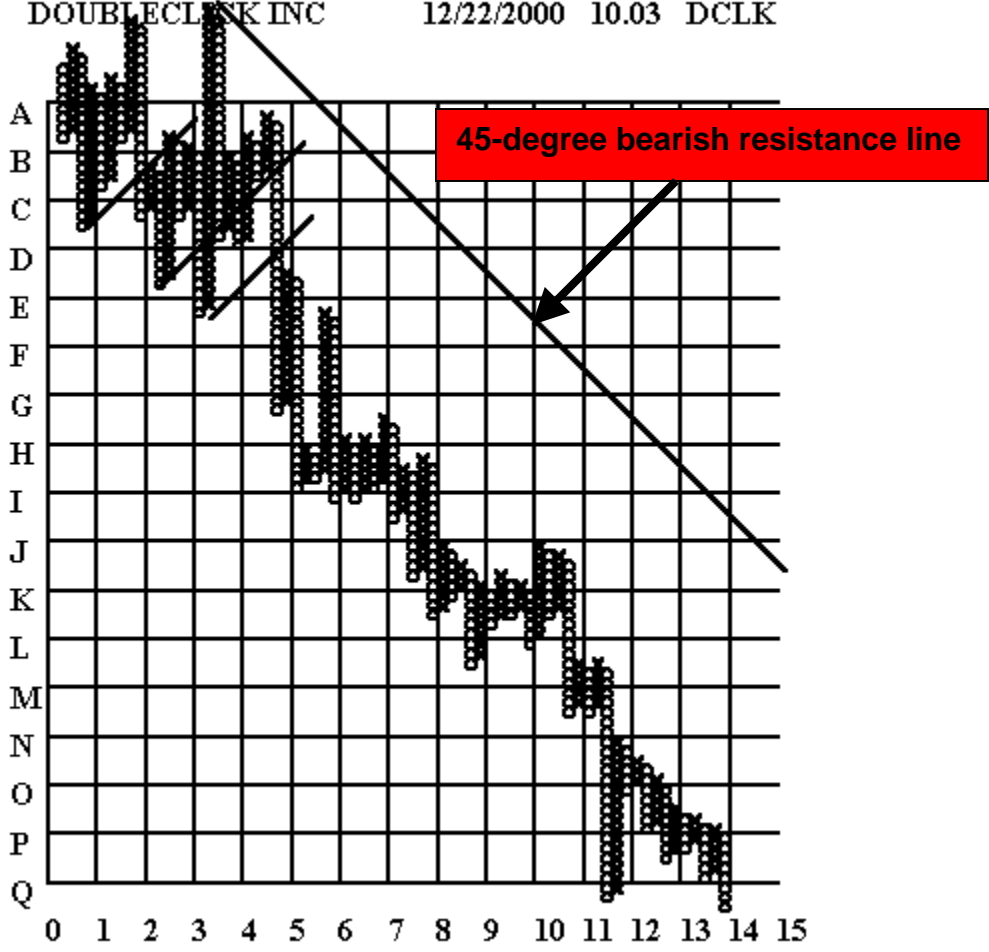
Losers occupy a position in the portfolio that could be invested in a winner.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
PSINET INC 12/29/2000 .72 PSIX



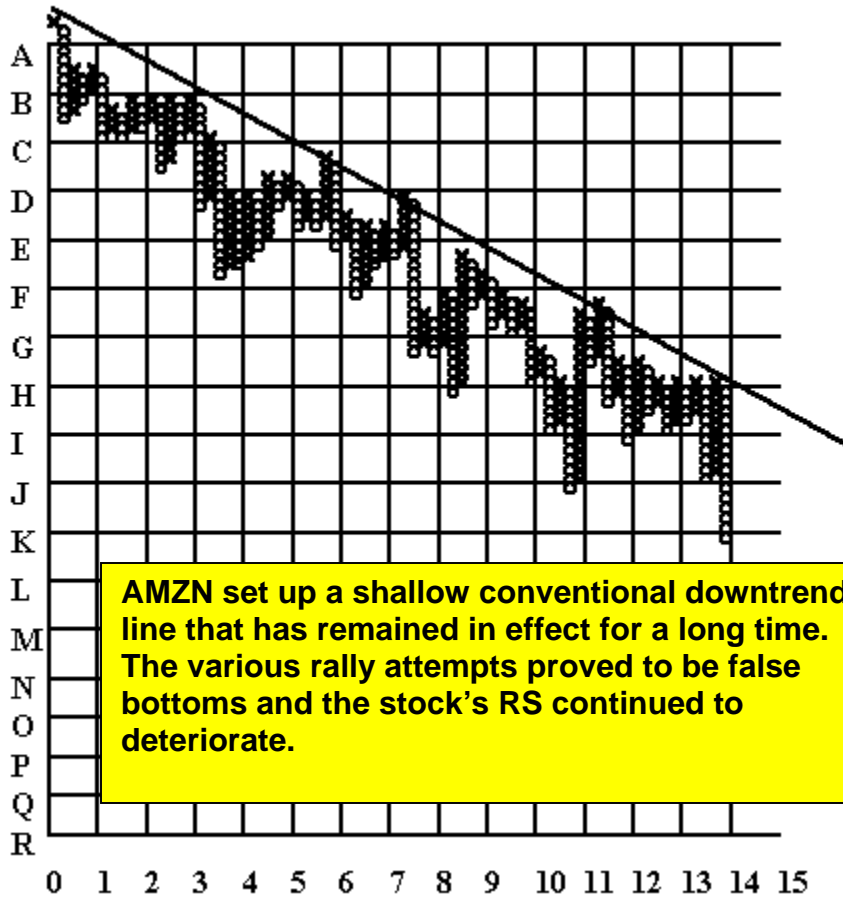
The portfolio manager must be able to diagnose and act on the transition from winner to loser.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
DOUBLECLICK INC 12/22/2000 10.03 DCLK



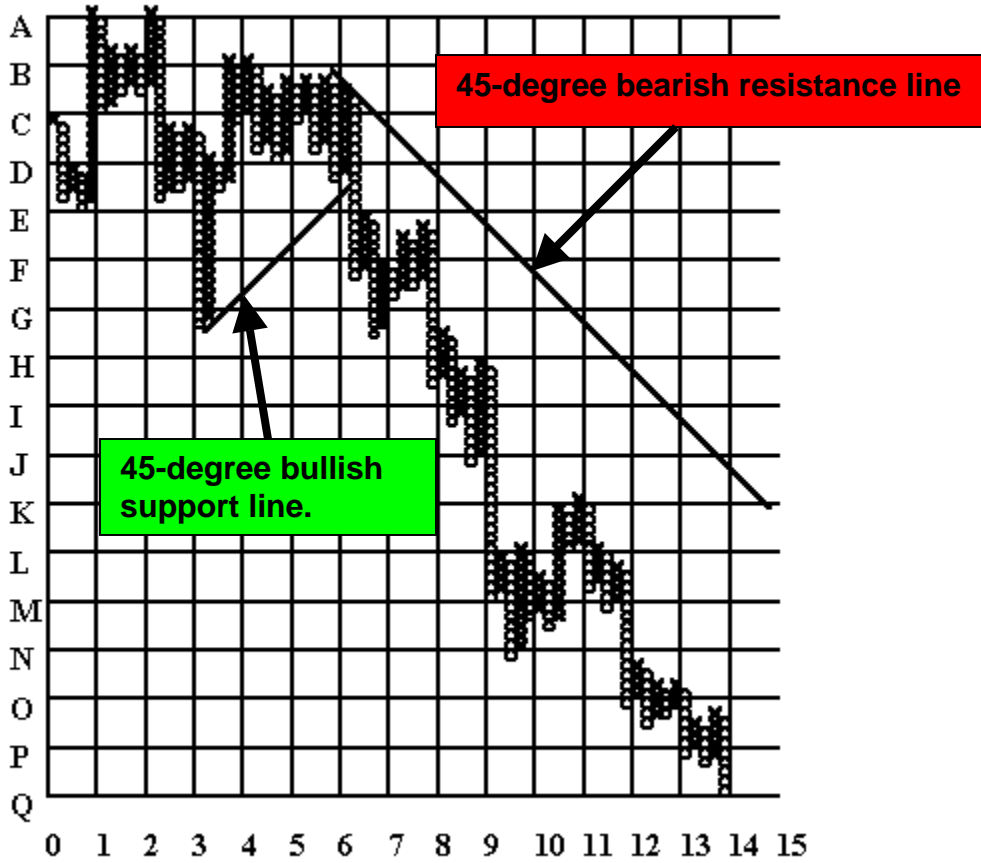
The identification of problem stocks in a timely manner drives the portfolio upgrading process.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
AMAZON.COM INC 12/22/2000 15.56 AMZN



There is a tendency to underestimate downside risk.

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
YAHOO! INC 12/22/2000 29.56 YHOO



Summary and Conclusion

Damage control is an exceedingly important part of successful portfolio management. The identification of non-performing stocks is critical to the achievement of performance objectives.

The long-term relative strength charts in point and figure format are ideal for tracking the performance of stocks in the portfolio. The 45-degree bullish support line provides an easy test to assure that the stock is perforating up to expectations. Stocks that fall below the 45-degree bullish support line can be switched into more promising issues.

This process of continual portfolio upgrading is key to the long-term performance of the portfolio. The upgrading process allows the portfolio to adapt to changes in fundamentals on a timely basis.

Non-performing stocks will be eliminated from the portfolio while the loss is still manageable and major disasters will, for the most part, be avoided altogether.

In my opinion, portfolio managers should worry less about taking profits and more about the elimination of non-performing stocks. As Peter Lynch said “we should water the flowers and pull the weeds”.

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