Market Dynamics

Volume 10, Issue I25

June 24, 2011

Performance Management System

Why Reversion To The Mean Doesn't Always Work

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

Ignat's Law

"I never buy at the bottom and I always sell too soon."

Baron Rothschild

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

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I once had a brokerage client who, as an RIA, actually implemented a strong form of the contrary opinion strategy to the management of client portfolios. This was not a casual test because he was very systematic and disciplined in his application of the technique. He calculated the mean and standard deviation over a five year period, on a hand held calculator, for a large number of big cap stocks. He then calculated a z-score based on the current price and the mean and standard deviation from the price history. (A z-score measures the number of stand deviations a stock is away, either above or below, from the mean.) Then he selected stocks to buy with a z-score of –3 because he wanted to buy oversold stocks that were depressed and cheap. He applied this methodology over a long period of time to a large number of stocks.

In some years he had spectacularly good performance relative to the market. But in other years his performance was horrible. As it turned out, he found a large number of winners. but in some years the proportion of major disasters turned out to be so large that the losses outweighed the gains. Why?

He believed that "what goes down has to go back up" but that is not always true in the stock market. Some stocks developed severe fundamental problems that turn out to be long-term in nature and might not reverse over a long period of time or perhaps the problems were terminal. These stocks became oversold and showed extremely negative z-scores as the downtrend persisted and his methodology drew him into these disastrous stocks. Like many individual investors who buy a stock that is oversold (cheap) when he buys it, he couldn't reverse his position as the loss expanded.. This lack of flexibility caused him to ride stocks down to unreasonable losses.

His experience was very instructive to me and I studied his methods to find out what was going wrong. Naturally, his opinions about a stock and mine often differed dramatically because my opinion was based on the trend of the stock price. Stocks that had become very oversold always showed a very negative trend on my point and figure price charts and I couldn't recommend buying them despite the fact that they were cheap.

As it turned out, I had learned to buy stocks that had gone down in price, as he did, but there was a big difference in my application of contrary opinion. I required that a stock build a broad base at a low price level before I was ready to buy it. The base on the long-term point and figure charts was an essential piece of evidence that the stock had stopped going down. More often than not, the base proved to be a period of accumulation that led to a future up trend. The base was the essential difference in the application of his system of contrary opinion and mine. The requirement of a base kept me from buying stocks in "free-fall" that appeared so attractive because of a high negative z-score (i.e. cheap).

I didn't buy stocks at the bottom but I avoided the major disasters that plague contrary opinion investors. The experience has reinforced my belief that a major base is what is critical in finding stocks to buy. It is not completely foolproof, but it does avoid many of the major investment disasters that occur all too frequently in the stock market.

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