

What Does A Downgrade Really Mean?

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

Ignat's Law

**“The race is not
always to the swift nor
the battle to the
strong, but that's the
way to bet.”**

Damon Runyon

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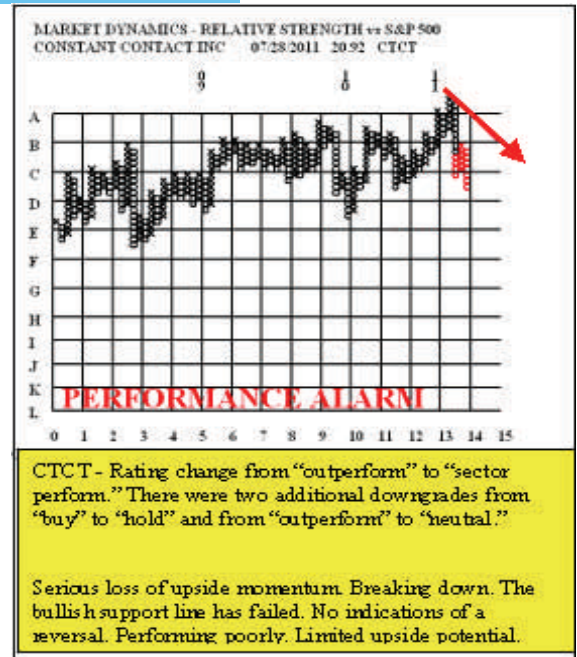
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This is an example of a stock that was downgraded by three different analysts. The chart was included in the TPARC report for July 29, 2011. The three different downgrades are listed and my technical opinion is shown in the text at the bottom of the chart.

The chart clearly shows a “serious loss of upside momentum” and that the chart pattern was “breaking down.” This is a standard long-term, point and figure chart of relative strength prepared using Market Dynamics. My chart opinion clearly states that the stock appears to be “Performing poorly” and my conclusion was that the stock offered “Limited upside potential.” A stock that carries an opinion of “Limited upside potential” should not be held as a long position in a portfolio. In other words, it should be sold.

The analyst's rating changes downgraded the stock from “buy” or “outperform” but the new rating was listed as a “hold” or a “neutral” or a “sector perform.” The dates of the analyst's previous “buy” or “outperform” rating are not known so we can't tell whether the stock produced a gain or a loss based on the analyst's previous rating. What we do know is that the stock is now trending down in a serious way. And yet, the analysts were suggesting that the stock was a “hold” or “neutral” or a “sector perform” rather than an outright “sell.” This failure to issue a “sell” rating on the stock is a very common occurrence on Wall Street.

Seasoned, professional investors know that a downgrade to a



rating of “hold” can be a serious negative for the stock. They almost automatically translate the downgrade into a “sell” in their opinion. Casual individual investors may accept the rating of “hold” as literally a recommendation to continue to hold the stock in their portfolios. As a result, many individual investors continue to hold stocks that should be sold.

All investors should always seek a second opinion from the long-term charts of relative strength to determine if the stock should be sold or not. If the trend on the long-term chart of relative strength is clearly down, the investor should ignore the analyst's “hold” rating and sell the stock. This double check provided by the chart can be of great value to all investors when analysts change their opinion on a stock. The only prediction that is involved is that if the stock has been trending down, it will probably continue to trend down and that has proven to be the right answer more times than not.

W. Clay Allen CFA

