Market Dynamics

Volume 7, Issue 114

October 17, 2008

Performance Management System

"The Future's Not Ours To See"

Portfolios heavy with under-performing stocks almost never outperform the market.
Ignat's Law

It is well known that long-term investors who focus solely on fundamental analysis often do not recognize bad stocks in a timely manner. In other words, the failure to systematically observe the performance of each stock in the portfolio leads to problems with the sell decision.
Good stocks go up randomly and bad stocks go down randomly, but the observant investor can certainly tell the difference between the two.

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Last Saturday, my wife and I participated in the Columbus Day parade here in Denver and after the parade we went to a big Italian party at the lodge of one of the Italian clubs. There was a large crowd and plenty of food and drink and they even had a very good mandolin player to entertain the crowd. Since most Italians love to sing, it was easy for the mandolin player to start a sing-along. When he started playing the song "Que Sera Sera" the crowd sang along enthusiastically.

The words to the chorus of that song really struck me. I think I was still a little disturbed by the events in the stock market during the prior week. The chorus goes like this:

Que Sera, Sera,
Whatever will be, will be
The future's not ours, to see
Que Sera, Sera
What will be, will be.

I guess I was in a reflective mood but the message that "the future's not ours to see" struck home.

Somehow when dealing with the stock market we often hold ourselves responsible for seeing the future and that is probably an impossibility. It seems more reasonable to believe that we cannot accurately see the future and therefore we should limit our commitment to predictions of what the stock market will do in the future. It is almost certainly true that we cannot the predict the future of an individual stock

Experience shows that strongly held convictions about a prediction of the future performance of a stock can lead to serious mistakes and large losses. This experience is repeated by many investors over and over in the stock market every year.

Years and years of experience have taught me one very important lesson about the stock market. The stock market is full of surprises. What this really means is that widely believed expectations of how a stock will perform are often completely wrong. Stocks where a majority of investors and analysts had high hopes often disappoint and dull and listless stocks that nobody cares about often become big winners. This seems to be a basic pattern of behavior in the stock market.

If we truly believed the other message from the song that "whatever will be, will be" we should spend most our efforts trying to observe what is actually going on in the market with individual stocks and act accordingly. It is the actual process of observing a stock's performance that leads to correct behavior in the stock market. These observations allow us to adapt to changing conditions while those forces are still in flux. It is said that "constant change is the only constant" in the stock market. Are we better served to try to predict those changes with fundamental forecasts of the future or should we try to adapt to those changes as best we can based on observations drawn from the actual behavior of the market?

Most seasoned investors tend to use a combination of fundamental analysis and market observations usually called technical analysis. There is, however, a subtle shift in emphasis on the weight given the two schools of analysis when the investor is evaluating the performance of a stock that is already in the investor's portfolio. It seems that when the investor is at risk, he already owns the stock, the observations of the stock's performance are given more weight than the fundamental forecast that may have led to the purchase of the stock in the first place.

This increased weight given to the observations of each stock's performance is a very important factor in allowing the investor to recognize those stocks where the forecast is not working out as expected. These stocks are not performing as expected and should probably be eliminated from the portfolio. This is the essential step in the process of adapting to change.

I believe that investors should weight the buy decision for a stock about 80% fundamental and only 20% technical. The sell decision, on the other hand, should be weighted more heavily in favor of technical analysis, about 80% technical and only 20% fundamental.

The constant evaluation of the performance of the stocks in the portfolio actually leads the portfolio manager to hold the stocks that perform well, for as long as they perform well, and to eliminate the poorly performing stocks as soon as their performance becomes unacceptable.

Que Sera Sera

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