Market Dynamics

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Performance Management System

Relative Strength—A Tool For Measuring Performance

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

Ignat's Law

No trend lasts forever!

The investor must follow the trends on the relative strength charts to know when the trend fades or changes direction.

Relative strength is usually expressed as the ratio of a stock's price to a major market index. If this ratio is increasing over time then the stock is considered to have good relative performance. Conversely, if the ratio is declining over time the stock is performing worse than the market. This is very useful to many professional portfolio managers since they often measure their own success or failure relative to the same major market index.

There are several popular measures of relative strength that are being used by professional investors. One system compares the movement of the ratios over a period time and performs a ranking from strongest to weakest. The other approach is to use trend following methods to track the movements of the relative strength ratios. Each method has its strengths and weaknesses.

Many investors shy away from relative strength ranking systems because the strongest stocks are the stocks that have already experienced the biggest moves relative to the market. To these investors the move has already been missed and the inevitable correction or reversal could produce large losses. Some investors look for changes in ranks to select stocks with improving relative strength.

It seems that trend following methods offer several advantages such as earlier entry into investments with improving relative strength. If the ranking system covers a long "look-back" period for its ranking, then changes in trend may be overlooked.

The trend following methods usually use charts of the ratios over time to evaluate the trend. The ratios are usually calculated by using the S&P 500 index as the divisor in the calculation of the relative strength ratios. These charts can be constructed in such a way to remove the meaningless noise and random variation from the stock price data.

The investor does not have to believe that the trend will continue in order to use these charts effectively. Once a trend becomes established, the trend will be presumed to continue into the future. This is usually a good assumption

However, the investor should commit to following the trend with the chart until it loses strength or changes direction and then appropriate action can be taken. If the trend persists, then good returns might be realized. As soon as the trend changes direction the investor will know to change his position.

In this way, by measuring the trend of relative strength the investor will be participating in good stocks, for as long as the trend of good performance lasts. Stocks whose relative strength trends turn down will be deleted form the portfolio. This will produce the dual benefits of retaining winners in the portfolio and eliminating the losers.

This is a more dynamic approach to investment management and it is less reliant on stock market predictions which can prove to be so disastrous. The real lesson to be drawn from the randomness of stock prices is to avoid predictions and to adapt to the changing market conditions as they occur. This is best accomplished by following the trends on the charts of relative strength.

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