Market Dynamics

Volume 9, Issue I11

March 12, 2010

Performance Management System

How To Know Which Stocks To Avoid

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

Ignat's Law

A stock with poor market performance is a stock that should be avoided unless the investor has special or inside information about the inner workings of the company. Even then, it is probably better to wait for the market performance to improve before buying the stock.

One of the most important skills an investor can develop is the ability to know which stocks should be avoided. At any point in time, between two thirds and three fourths of all stocks offer little chance of outperforming the market and should be avoided. The best way to determine if a stock falls into the avoid category is with a long-term point and figure chart of the stock's relative performance.

It is basic to investment theory and practice that a stock's market performance will, sooner or later, reflect the actual financial performance of the company and the expectations of investors for its future performance. In many ways, the historic market performance of the stock will tell the investor whether the stock should be avoided or not.

Persistent, long-term patterns of poor performance by a stock are not accidental. They may be random but they are not accidental. The financial performance of the company and the expectations for its future performance are lacking in some important aspect and this is reflected in the poor performance of the stock. The relative market performance for a good company with above average financial performance will usually not under-perform the market as measured by a popular index such as the S&P 500.

If the stock has a history of poor market performance, it should be avoided and excluded from further consideration as a long-term investment. This simple rule will eliminate probably twenty-five percent to thirty percent of all stocks. The poor market performance for these stocks will show up as a long-term downtrend relative to the market. These stocks should be considered as problem stocks and keeping them out of the portfolio helps the portfolio manager avoid the losers. The Market Dynamics charting system will color code these stocks with a red flag on the chart and a notation that the stock is under a "Performance Alarm."

The remaining thirty to forty percent of all stocks do not have bad market performance, per se, but they don't have good performance either. These stocks often show a pattern of performance that can best be described as a trading range. Not terrible, but not good either. The stock moves up and down but there is no sustained trend of performance that is better than the market. This shows up on the long-term point and figure charts as a horizontal, back-and-forth movement across the chart. The majority of all stocks fall into the trading range category. These stocks should be avoided because they don't offer a good prospect for outperforming the market.

The investor has limited time and resources to find and participate in good stocks with the ability to outperform the market. The investor should not waste time doing fundamental research on stocks whose historic market performance indicates little hope of finding a winner. This test can be applied easily and quickly with a simple review of the trend of performance shown on the long-term point and figure charts of performance.

If the stock is still going down or showing a trend of lackluster performance relative to the market, it is best avoided until the performance improves. This is a simple test that can save time and keep problem stocks out of the portfolio.

W. Clay Allen CFA

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

Please visit the web site at http://www.clayallen.com/

Market Dynamics
7325 S. Jackson St.
Centennial, Colorado

Phone: 303-804-0507

clayallen@msn.com