Market Dynamics

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Performance Management System

How Relative Strength Can Help Long-Term Investors

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

Ignat's Law

There seems to be little doubt that the expected financial performance of the company is reflected in the price of the stock. It follows that the movements of price provide an insight into the expectations of investors about that stock.

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

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Market Dynamics
7325 S. Jackson St.
Centennial, Colorado
80122

Phone: 303-804-0507

clayallen@msn.com

Many investors shun the use of charts altogether and as a consequence they ignore a source of extremely valuable insight into the performance of their stocks. Relative strength in a long-term format helps a long-term investor evaluate his holdings based on comparisons of their performance in the market, rather than emotional hopes and "expert" opinions.

Relative strength is based on the ratio of the stock's price to the overall market, usually the S&P 500 index. If the stock is outperforming the market, the relative strength ratios will increase over time. Conversely, poor relative performance by the stock will result in ratios that decline over time. If the stock moves in step with the market it will show a graph of its relative strength ratios that moves in flat line across the chart.

The proper application of relative strength charting is to record and measure the stock's performance relative to other stocks. However, the charts do not provide forecasts of the future price of the stock. There is little doubt that the expected financial performance of the company is reflected in the movements of the stock. Therefore, the movements of the relative strength chart provide an insight into the financial performance of the company and, more importantly, how investors view the likely performance of the company in the future.

There are two sources of price change for a stock that are removed by the long-term point and figure method of charting of the price of the stock relative to the market. The long-term 3-box method of P&F charting acts like a filter on the price data and the noise is removed from the chart. The use of relative strength removes the influence of the overall market on the stock and what remains is the price movement that is specific to that stock. It is common for stocks with good relative strength to move persistently upward across the chart. Conversely, a stock with poor performance will show a persistent downward trend on the chart.

These trends are of immense help in deciding which stock to hold and which stock to sell. A stock with poor performance should be removed from the portfolio. Stocks with good performance should be retained in the portfolio for as long as the performance remains good. The various fundamental methods for picking stocks for investment, all result in the conclusion that the stock will outperform the market. Relative strength provides a technique for testing the hypothesis that the stock will outperform the market. If the relative strength chart does not confirm the stock's ability to outperform the market, the long-term investors gains a very useful insight into the validity of the fundamental analysis that led to the purchase of the stock in the first place.

If the stock cannot perform as hoped, it becomes a candidate for sale and replacement with another stock with better performance. The only forecast is the proposition that what has been happening in the recent past will probably continue in the future. This forecast is based on the long-term trend of relative strength and that, in turn, is based on the reflection of the financial performance of the company by the stock.

Long-term investors stand to benefit handsomely from following these long-term trends of performance shown by the relative strength, point and figure charts.

W. Clay Allen CFA