Market Dynamics

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Performance Management System

# Every Stock Should Pass The Performance Test

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

**Ignat's Law**

**The long-term movements of a stock's market performance may fluctuate back and forth in a random fashion but these long-term trends are not accidental and they usually reflect expectations about the fundamentals of the company's business.**

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One of the most effective tools of portfolio management is the performance test. The performance test is based on the long-term trend of relative performance. In order for a stock to qualify as a purchase candidate, it must show an upward trend of relative performance. The ability of a stock to remain in the portfolio also depends on an ongoing verification of the stock's positive performance in the market.

The requirement that a stock must show a positive trend of performance eliminates many stocks from further consideration. This tends to focus the portfolio manager's attention on potential stock market winners for further research. In this way the performance test keeps many problem stocks out of the portfolio. The higher the concentration of the portfolio in stocks with positive trends of performance, the greater the probability of achieving good long-term investment performance.

The portfolio manager must continuously monitor the performance of all the holdings in the portfolio. A stock may have had a good performance trend when it was purchased but sooner or later that positive trend of performance will turn down. The performance test determines which stock should be retained in the portfolio and which should be removed from the portfolio. This process keeps the portfolio fresh and current. It allows the portfolio to adapt to changes in market or business conditions. This is often termed "portfolio upgrading" and it is an essential part of portfolio management.

The performance test should be based on the long-term trend of relative performance. The test must filter out the short-term random squiggles of the price and allow the long-term trend to show through. A long-term point and figure chart of performance will reveal the long-term trend as a pattern of higher highs and higher lows on the chart.

The portfolio manager is constantly on the lookout for holdings in the portfolio whose relative performance is turning down. Many times these changes in the trend of relative performance will follow a horizontal pattern on the chart that develops into a major top. It is always best to eliminate these stocks before the damage to the relative performance becomes serious.

A distinction must be made between the use of a long-term performance chart to measure and test performance as opposed to making a precise prediction of how the stock will behave in the future. A core part of this approach rests on the belief that once a long-term trend of performance has been established, it will probably continue into the future.

The key here is to focus on the long-term trend of relative performance which often continues for fairly long periods of time. Ben Graham indicated that the stock market was a "voting machine" and the long-term charts of relative performance show how the votes are being cast.

Many long-term portfolio managers are far too complacent about stocks in the portfolio that show poor performance. Knowing which stocks to sell and which stocks not to buy is a key ingredient of successful portfolio management.

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