Market Dynamics

Volume 9, Issue I5

January 30, 2010

Performance Management System

Keeping The Portfolio Fresh And Performing Well

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

Ignat's Law

Portfolio upgrading keeps the portfolio fresh and increases the portfolio's potential for future performance. Portfolio upgrading begins with the identification and elimination of the stocks with poor performance.

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

The portfolio manager's primary responsibility is to manage the portfolio in order to keep it fresh and "in-step" with the currently positive trends in business conditions and the stock market. In a modern dynamic economy these factors are constantly changing. These trends wax and wane in terms of strength and can even change direction completely as the business cycle evolves.

To keep the portfolio fresh and benefiting from these positive trends, the portfolio manager must remain flexible and adaptive. He also must measure the performance of every stock in the portfolio in order to identify those positions whose performance has become unacceptable. These are the stocks that need to be replaced in order to keep the portfolio positioned for good performance in the future. It is the stocks with bad performance that should catch the attention of the portfolio manager.

Successful portfolio managers know that stock selection mistakes are inevitable and he needs a plan for dealing with those stocks that don't work out as hoped. Removing the stocks with bad performance from the portfolio is the first step in upgrading the potential of the portfolio to generate good performance in the future. Surprisingly, the key to good performance is the ability to identify those stocks that are detracting from the performance of the portfolio. Most portfolio managers spend most of their time and effort trying to find the next big winner in the stock market but good portfolio performance depends more on finding and eliminating the bad stocks from the portfolio.

It is important to review the performance of a large number of stocks to find the stocks with improving performance characteristics. Experience shows that good stocks are always in the minority. At any point in time, approximately 25% to 30% of all stocks will be trending down and should be avoided. Another 40% to 50% of all stocks are performing "in-line" with the market and offer little hope of generating excess returns. That last 25% to 30% of all stocks are performing well and are among the candidates to replace the poorly performing stocks in the portfolio. Probably half of the final group of stocks have had such big moves to the upside that chasing them might be a mistake. Probably no more than 10% to 15% of all stocks are worthy of consideration as a purchase at any point in time and that group of stocks is constantly changing.

The portfolio manager needs to focus on this small minority of all stocks to concentrate his investment research. The portfolio manager's most limited resource is his time to review and evaluate potential buy candidates. This upgrading process allows the portfolio manager to concentrate his efforts on those stocks that are showing good long-term trends of performance. The long-term charts of relative performance should be used to evaluate the recent trends of performance. The portfolio manager is not using the chart to predict the future price of a stock, but to evaluate its performance. Persistent, long-term trends of performance are not accidental and, more often than not, that good performance can be expected to continue into the future.

W. Clay Allen CFA