Share Trading**

Ranking stocks by performance

Introduction

Let's say that we invest (or trade) in shares, and that we have a reasonable stock selection strategy that tends to identify good shares that are worth investing in. However, we currently have too many stocks on our buy list. (There are a couple of reasons why we shouldn't buy several stocks all at once — see comments below).

So, given that we have this problem of too many candidate stocks for purchase, how do we decide which ones to invest in today, and which ones to leave for a few days?

If one of our key investment criteria is to make good capital gains, then it makes sense to focus on the stocks that have a strongly performing share price. So we need to look at our list of candidate stocks, and rank them in order of share price performance. This means finding a way to quantify the price performance, and then rank them to compare one to another. But how can we do that quickly and easily?

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This Article in Brainy's series on Share Trading and Investing (number ST-6070) discusses some of the issues regarding stock selection methods, and contemplates how to quantify a company's share price performance — and how to rank a list of stocks.

Ranking possibilities

For stock purchase decision-making, long term investors might look at the fundamentals of the companies, and utilise fundamental analysis criteria such as:

- PE ratio (either the historic PE or the forward PE);
- ROI, ROE, TSR – Return on Investment or Equity, or the Total Shareholder Returns;
- EPS – Earnings per Share;
- CAGR – Compound Annual Growth Rate.

But in reality, are these useful? Certainly they can greatly assist with identifying companies that are likely to perform over time, and which might be run with a good management team. But they don't say anything about “mister market's” opinion of fair value. (Remember that my opinion of the fair value (or intrinsic value) for a company is not very useful if all the other market participants don't agree.)

Another complication is that all investors are not the same. Amongst the myriad of possibilities for judging value, and worth, and stock picking, many investors will have somewhat different opinions about **how** to do this.

Share price performance

Many successful traders and shorter term investors tend to focus strongly on share price performance, utilising strategies that are based on clichés such as “*the trend is your friend*” (in which there is a lot of merit). They argue that the price chart summarises the opinions (and emotions) of the market participants, and it doesn't matter what opinion you have regarding fair value (or intrinsic value), the real worth of a company's shares today is the traded price on the market. And today's close price is, therefore, the true perceived fair value today.

Strong stock performers

In a raging bull market there will be many stocks that move strongly upward – this is what makes the bull market. In times like this, many investors and traders find it easy to make money by buying

** - The two words *trading* and *investing* are often used somewhat interchangeably.

shares in the strong performers. New-comers to the market at this time tend to be fooled into thinking that making money in the markets is easy. This happened in 2008 after the strong bull market from 2003 to 2007.

However, in a bear market, or when the market index is simply moving sideways, not many stocks are moving strongly. So it is not so easy to pick the winners; but there are ways to do it.

Dependencies

There are a few complications when considering a stock ranking method, including the following:

- Our investment objectives and risk tolerance:-
  - Are we aggressive? or
  - Conservative?
- Investment horizon — are we investing with a short or long term perspective?
  - Weeks?
  - Months?
  - Years?

Not only that, but how much time do we want to commit to our investing activities each week? Perhaps a couple of hours each week, or an hour or two each day, or maybe only an hour or so each month? All these factors will impact on our decisions regarding a stock ranking method.

Dividends — distracting?

And what about dividends? Are they important to us for income? Or perhaps they are more a distraction?

Many investors are so convinced that they need dividends for income that they invest in the high dividend paying stocks, regardless of the share price performance. Other investors and traders make stock purchase decisions regardless of the dividends. If a dividend is available whilst they own the stock, then well and good.

Why not buy many all at once?

It was mentioned above that if our stock selection strategy identifies several stocks, then perhaps we should not be buying all of them all at once. There are a couple of reasons for this.

Firstly, we need to recognise that the share prices generally move up and down from day to day. And a share in a rising trend tends to move a few steps forward, and then back a little, then up a few more, then back a little. This cyclical activity is not totally predictable. We might buy a stock just before it moves down for a few days. And having bought it, we might find that the price continues to fall — perhaps because of new bad news. This can result in a loss-making position which we might want to sell quickly to minimise the loss.

Secondly, when investing (or trading) in the share market, we need to recognise that we will not be able to be 100 percent successful with our investment purchases. A short to medium term investor/ trader who is prepared to sell a stock to protect capital (and lock in any profits), will know that some losses are inevitable. One of the reasons that losses occur is because of market sentiment impacting on groups of stocks, or a whole sector.

Thirdly, the first thing we want to see with a new position in the market is that we move into profit. For this to happen, the share price needs to rise high enough to cover any brokerage costs and slippage. Then once into profit, many investors/traders will lift their initial stop loss level to a trailing stop loss level that will have a greater chance of a good profit. Unfortunately, it can take several days or weeks for a stock to move into a profit position.

Given the above possible scenarios, the last thing we want to do is buy several stocks, and then watch all of them fall due to new bad news, or general bad market sentiment, or whatever. This is because the loss on each position will compound into a much larger overall loss. It can be very prudent to wait for the first position to move into profit, and then open another position.

Market home truths

The following home truths won't be news to those who are following the markets and the bigger picture (with reference to Figure 1 below):

- **The market index has gone nowhere in 8 years!** — At at the time of writing (June 2014), it can be seen that the market is at the same level as back in November 2006. Since then it went up to the 2007 peak, fell to the 2009 trough, rallied into 2010, then travelled mostly sideways before the last rally from mid-2012.. The market is up more than 70 percent since the 2009 lows, but is still at the levels of 8 years ago (2006). This means that anyone investing in an index fund in 2006 does not have any profit to speak about.

Figure 1: The All Ordinaries index (XAO) from 2004-2014.

- ***But the market index has rallied recently (2012-2014)*** — It is no secret that since the last significant market low in September 2011, the index is up more than 35 percent.
- ***Some stocks perform sometimes***. Even when the markets are stumbling, or falling, there are often some stocks that are trending higher. The secret is to know how to find them.
- ***We can't rely on blue chips*** — Anyone who focuses on blue chip stocks will know that even these can fall significantly when times are tough. The title “blue chip” is certainly not a guarantee of share price performance. In fact, by definition, it is simply a statement that the company is likely to be around for the long-term [1].
- ***Dividends are great*** — In 2014 there are many companies succumbing to the demands of investors and offering more than reasonable dividend returns. Many investors are now relying on the dividend income stream continuing into the future.
- ***Capital improvement can be realised with careful stock-picking***. In almost any market environment, it is possible to achieve returns on capital with careful stock picking.

One strategy approach

Based on the home truths listed above, one possible approach to tackle today's tough market conditions is as follows:

- Ignore the longer term, and focus on the short to medium term (ie. weeks to months).
- Focus on capital returns from improved share prices (maximise profits, minimise losses).
- Take dividends, by all means; but don't get carried away chasing the dividends. This could distract from a primary goal of achieving capital returns.
- The shorter time frame means that proceeds from share sales could be used as income, so that dividends may not be so important.
- One possibility is to focus solely on share price increases, and ignore dividend opportunities.

1 Refer ASX web site: http://www.asx.com.au/glossary/items/blue_chip.htm

It is very useful to remember careful money management strategies such as:

- Quit losses quickly to keep them small, and
- Let the profits run.

Don't forget the win/loss ratio — provided our losses are kept small, and the profits are larger, then a win/loss ratio as low as 40% can be profitable. And it pays to remember that we can go broke taking profits, if the profits are not large enough to out weigh the losses.

Quantifying price performance

Given all of the above background information and strategy assumptions, we need to consider the possible methods for measuring share price performance over time. The most obvious and simplest way is to simply calculate the change in share price over a given time period, convert it to a percentage. However, because of the day-to-day fluctuations of many stocks, this measure could vary significantly from week to week.

Figure 2: AWE weekly price chart.

But take a look at the weekly price chart of AWE in Figure 2 at right. The simple triangle trend-ruler tool indicates a price change of 46 percent over the 24 weeks indicated. Of course, this measures the price change between two specific points on the price chart. However, if we were to measure the price change between two different points on the chart, the resulting price change percentage might be very different. One tool to overcome this issue is to use a Moving Average of the share price.

Moving average of share price

Using a moving average measure of the share price will smooth out these variations. But there are many variations of moving average to consider.

The price chart in Figure 3 at right is the same price chart as above in Figure 2, but with two Moving Average (MA) curves added — a 15 week MA (blue), and a 30 week MA (red).

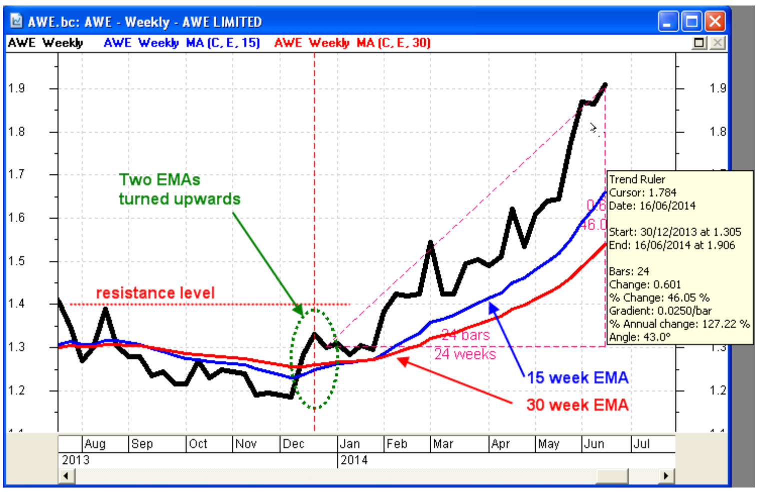

Figure 3: Moving average of the share price.

Notice that even though the slope of these two MA curves change over time, the change is gradual from week to week. If we can quantify the change in the MA over just a few weeks, then we can compare this value to that of another stock.

For further discussion on these moving averages, and what they are telling us, and how to interpret them, refer to Article **TA-6500, *"Tools for ranking stocks"***.

Additional tools...

It would be useful to mention that there are additional tools for measuring, and comparing, share price performance over time. But like the moving averages mentioned above, they are technical analysis tools that utilise features of the share price chart. Some of these are also discussed in Brainy's Article **TA-6500, *"Tools for ranking stocks".*** For a real case study sample of how to use a software program to rank a list of stocks, see the Article BC-10-410 which shows how to do this in the BullCharts charting software package.

Summary

In this article in Brainy's series on Share Trading and Investing (number ST-6070) we have considered the usefulness of being able to rank a list of stocks by share price performance, and one of the tools available to do this.

For more information, refer to:

- eBook Article ***TA-6500, "Tools for ranking stocks";***
- eBook Article ***BC-10-410, "Scan sample using BullScript"***.

For more information on Share Trading, or
Technical Analysis, or BullCharts software,
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Brainy's Share Market Toolbox: www.robertbrain.com

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