Mission: Impossible

By Roger Balser

April 2015

Is It Really Impossible to Beat the Market?

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For much of the last 25 years, most of the media and investment management world have promoted the idea that individual investors can't beat the market. And it's true. You can't beat the market. That is, unless the stocks or mutual funds you own are, in fact, beating the market!

There is no way on earth you could ever beat the market if the stocks or mutual funds you hold are not keeping pace with the market, or with any luck, staying ahead of the market.

However, that's what the majority of investors attempt to do. They would rather keep all of the "dogs" in their portfolio and even put it all on the long-shot dog to win. Can this strategy pay off? Sure it can, but in reality it probably won't.

Perhaps you don't want to beat the market overall. You just want to own the best retail stocks, or the best gas and oil stocks, or the best commodities. But how could you even know if your stocks or mutual funds are beating the market, or are the best names to own in their respective sector?

As a long-standing player in this business, the best market indicator I've experienced is something called *relative strength*.

What Is Relative Strength?

Relative strength is simply the measure of how your mutual fund or stock is performing, when compared to a group of other stocks, funds, indexes, or the market overall.

According to Tom Dorsey of Dorsey Wright and Associates, relative strength is a comparison of price trend between one stock vs. another stock or an index.

"I think of relative strength as an arm wrestling contest," Dorsey says. "Take two middleweights whose physical statistics stack up evenly. Viewing both individuals would not, in this example, suggest one was stronger than the other. That is until they arm wrestle. In this contest person A easily beats person B. If A and B were stocks, the result of this contest would suggest you buy A over B. Nothing says in the long term that B can't go out and get a gym membership and ultimately build more strength than A. The point is we can easily check the relative strength any second we wish by clicking the mouse of a computer that is programmed to do the simple calculation."

So perhaps you want to compare Apple with other tech stocks. Maybe you want to compare Microsoft with the S&P 500 Index. Maybe you want to compare your mutual fund against the Dow Jones Industrial Average or the Standard & Poor's 500 Index.

It's a very easy calculation. Simply divide the price of your stock or mutual fund against whatever yardstick you've chosen. Using the fraction you end up with, just slide the decimal over so you can work with whole numbers. Then begin plotting that result daily on a "point and figure" chart.

But be patient. These relative strength charts move pretty slowly. Anything going up over time will be in a column of Xs. Anything going down will be in a column of Os. If you want to improve your odds of beating the market, the index (or whatever benchmark you choose), must be in a column of Xs and preferably be producing "Buy" signals.

Why is this? Well, if your stock or mutual fund is climbing in a column of Xs against the market (or a group of its peers), it has to be outperforming the benchmark. It can't go higher unless it's going up faster than the market overall.

Now, if your stock or mutual fund is going down against the benchmark you're using, it means your stock or mutual fund has poor relative strength compared to the index that you're charting it against.

Poor relative strength is something to steer clear of.

When the market starts going down and things look cloudy, stocks and mutual funds with poor relative strength (or on a relative strength "Sell" signal) will more often than not fall further and more rapidly than the rest of the market.

And stocks with a relative strength "Buy" signal can also go down with the market. However my experience has shown that stocks with positive relative strength or on relative strength "Buy" signals typically don't decline as much as the market overall. When the market recovers they're the first to bounce as the market picks up.

So in summary, relative strength can help you improve performance, preserve capital and eliminate the pain, frustration and emotion of investing. Choose to ignore it at your own risk.

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