



## **ClearStation Education: Portfolio Management**

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## Portfolio Management

### Risk Management

It's key to have a game plan going into the market. A good plan that you can stick to can increase your gains, cut your losses, and ensure that you come out ahead!

This section has some pointers on portfolio management and investment strategies. You should look them over, try them out in theoretical portfolios, and use them to help you develop your own trading strategy.

In this section, you'll learn:

- What to do before **taking a position** in a stock
- About new **investment strategies**

## Investing Is Re-Investing by kris

It is about as likely that you will invest well the first time and keep on investing well as it is that you would write a bestseller the first time you ever sat down to write and keep on writing bestsellers. Editing is an important part of writing. For that reason writing instructors have popularized the phrase, "Writing is re-writing." In other words, to write well, you must write once and then constantly improve your draft.

Investing well involves a similar process. The text is your portfolio and editing is the process of selecting, watching, committing to, and abandoning positions. You might say, "Investing is re-investing."

Even with the most expensive and sophisticated tools available, it is still very difficult to consistently make great stock picks. If you are a very good investor, you will probably pick one winner for every ten stocks you choose to monitor. If you are one of the top traders, one out of every five is a winner.

Those numbers don't sound very reassuring do they? So how do the top traders make money while being wrong 90% of the time? Through risk management.

The basic idea is to limit your losses and let your winners run. Let's say every trade you make is a \$10,000 trade. If you pick four stocks and lose 5%, but pick one and make 5%, your net gain will be 4% if you pyramid your successful trade.

When you catch a winning trend, that trend may last for weeks or months. The appreciation on a winning pick can be anywhere from 60% to 200%. Opportunities like these are relatively rare; therefore, when you find one you need to ride it for all it's worth.

So what about the losers? You need to be willing to sell your losers when they hit your risk limits. This approach guarantees losing money on a majority of your trades, but it also optimizes your ability to run with your wins when you find them; it's what's known as a strategy.

## **Strategy: How and Why** by kris

It is difficult to make money in the stock market by acting on tips. Tips are at best unreliable and cannot be counted on for consistent performance. At worst, they are poorly timed and can lose you money. So rather than following someone else's gut feelings, you'll be better off making -- and sticking to -- your own investment guidelines. Developing an original winning strategy that suits your own biases and preferences is the only way to achieve results in the stock market.

Selling a stock at a loss can be an emotionally troubling decision. The only way to do it peacefully is within a strategy that you can grow and groom dispassionately. It may sound absurd, but selling your losses should be performed with as much excitement as closing your winning trades. They must all take place within a well-honed strategy.

How does one acquire such a strategy? Most people just borrow one that appeals to them. However, the trick of any winning strategy is to make it your own.

## The Process of Investing by kris

Investing is a relatively simple process:

1. Choose a stock in which to take a position
2. Commit to the position by executing a trade
3. Monitor the trade to see if it fits your expectations
4. Close the trade when your expectations are met or lost

Easy enough, right? So why, then, is it so difficult to get any of these steps right?

### Step 1: Stock Selection

The first step in picking a stock is to start watching it. Putting a stock on your Watch List raises your awareness of the stock. It is rare to find a stock of interest and act on it immediately. A good Watch List is the key to successful stock selection.

If you are a technical trader, then price action is your primary motivation for selecting a stock to watch. If you are a fundamental trader, then earnings news or news of any other kind on a company is your motivation. Most investors combine these two disciplines. ClearStation's filtered lists are the most powerful tool you can use to limit the number of issues for further research, since every issue listed shows a compelling reason for action.

Once a stock is on your Watch List, you can compare its performance with that of other stocks you're watching. You can also find other information about that stock, to help you make a decision. Both technical and fundamental traders need more information on an issue before they can move to Step 2, committing to a position.

A technical trader may be more interested in finding additional statistical information on the issue. Has the stock exhibited this kind of price behavior before? What is the stochastic for the stock, the momentum? Is the stock in a strong MACD trend? A fundamental trader will scour news, earnings reports, industry reports, and analysts' reports to find information. As with picking stocks to watch, most people look at a combination of technical and fundamental information when deciding whether to move on a stock.

If even at your very best you are only going to pick one good stock out of ten, your Watch List should be a compilation of your best losers. Only your best winners will make it to your portfolio. That is, only the best of your Watch List will make it to Step 2.

### Step 2: Commit to a Position

Committing to a position is fairly straightforward: You contact your broker and execute the trade. However, there are several considerations.

First there is the side of the trade you wish to go on: long or short. Though the general tendency of stock prices is to go up, anyone who has made a losing position can tell you that in the short run, stocks are just as likely to go down.

In general, I stay away from short positions. They just take too much work. There are very few genuine short-side opportunities. And, if you take one, you need to monitor it twice as carefully as your long positions.

However, there is no reason not to take a short when you see it and it's in line with your overall strategy. Shorting in times of overall market uncertainty can yield significant gains. (ClearStation is the only Web-based portfolio manager that enables you to monitor both short and long positions with equal ease.)

Next there is timing. Many investors only execute on retrenchments. This means that they are convinced that a stock is trending and want to join the bulls or bears. However, they can't make a commitment until there is an opportunity. On a stock that is trending up, some may choose to wait until a down day, or the  $n$ th down day, before getting in. Others may wait for technical signals, such as stochastic, to make a commitment.

Finally there is your choice of broker. If you are an individual investor you probably use a discount service. After all, why pay for a service that you don't use?

If you want to share your decision with a financial advisor, spouse, or investment club, ClearStation makes it easy through its "recommend portfolio" subscription service. Any ClearStation member can subscribe to your recommend portfolio and receive an email notification as soon as you've decided to commit to your position.

### **Step 3: Monitoring the Position**

Monitoring your committed positions is the most critical aspect of the trading process. All of the information and investigation that went into your strategy and got you to pull the trigger in the first place is now put to the test: if you went long, are you finding more bulls by your side? If you went short, are you finding more bears?

Failing to monitor your positions can mean drifting into waters you never intended to enter. It can mean ending up with less at the end of the day, not more.

ClearStation enables you to monitor your positions in several ways, including their day-to-day fluctuations, whether they are going into or out of trends, the strength of those trends, whether other technical signals are being flashed, and what the investment community thinks of your picks. When your neck is on the line, it is important to pay attention to all of these items.

If you went long and your pick is going up, it is important to consider pyramiding up. If your long pick is going down, you have to know when to cut your losses.

When you do not get signals to reinforce your decision, get out early and often. However, when you do get these signals, you need to increase your position to increase your gains.

Getting in and out of positions costs less than it does to park your car. With so little to gain and so much to lose, it's hard to understand why some traders are afraid to sell as they lose 10%, then 15%, 20%, or even more on a bad call.

### **Step 4: Closing the Position**

If you picked a loser, you are already out. However, many investors do not know when and how to close a winning position. Paper profits can't buy you a new house or car. To make money in the stock market, you have to close the trade.

If you increased your position size as the stock went up, you may want to close the position in the same way, especially if the trend is not clearly showing signals of an end. Taking a few shares out to cement a profit is a good idea. However, you need to continue to monitor the issue so that you don't miss out on a continuing trend.

## Pyramiding by kris

I only make strong commitments to stocks that give me a lot of positive feedback. As a winning decision is confirmed, I double up or add even more to my position. That is, I pyramid up. The process of pyramiding up is one of the oldest and most successful strategies in investing.

For example, if I take a 100-share position at \$12 in a stock that I believe is trending up, and that stock goes to \$14, I have received my first confirmation of that trend. I add 100 shares to that position. Over the course of weeks, as the stock reaches subsequent price points, I add another 200, and so on. Say I have a total of 1,000 shares committed to this position and I notice some weakness in the trend, I start closing out just as carefully as I got in.

Pyramiding down is the hallmark of a losing investor. An investor with no risk management strategy who buys a stock at \$12 and sees it go to \$10 will think, "I thought it was a good buy at \$12, it must be a steal at \$10!"

However, this losing psychology has nothing to do with investment principals. Buying stocks is much different from buying any other type of item. In fact, there is no inherent value to a stock outside of the price the general public is willing to pay for it. Every stock can go to a value of zero.

A winning position is much like a precious crop whose value you must nurture by tending it.

## More on Pyramiding by kris

Pyramiding is the process of easing into and out of positions. In a perfect world, we would always pick the stocks that are moving the quickest, throw everything we have at them and exit at exactly the right moment. However, in the real world we must be more cautious.

Pyramiding allows you to move into those positions that allow you time to confirm a stock's prevailing trend.

Let's say that you have \$10,000 to spend on a stock that costs \$10 a share.

Pyramiding into the stock would mean buying only 100 shares on day one. As time goes by and you see confirmation of an upward trend (that is, it goes to \$11 and \$12), you add to your position, first by doubling up (an additional 100 shares) and then doubling that position (now at 400).

On some stocks like CSCO and MSFT, this process can go on for years, provided that you have the financial resources to increase your investments.

Eventually, the trend ends. Pyramiding out means closing positions just as cautiously as you got in.

Using pyramiding, you allow your winners to run and you limit your losses right up front. Also, there are as many variations on this technique as there are investors. Some people will double up while others triple up or more. Some investors will add fractional amounts.

Even best stock pickers are often wrong about individual stock selections. Their portfolios exhibit superior performance because they cut their losses early and they let their winners run. I never lose more than 10%. That's my personal parameter. If a stock goes from 10 to 9, I sell it regardless of how well I think it will perform in the long term.

Those are just my numbers. You'll find yours.

## Opportunity Management by kris

Opportunity management is the process of maximizing your gains. A necessary complement to the process of minimizing risk, it should form an important part of your overall investment strategy.

We are in an ever-increasing market where the choice is not between making or losing money, but between getting average or superior performance. Why should you be happy with 10% or 20% gains when the broad averages are doubling that? Successful opportunity management enables you to get in on the fat side of a trend and get out when an even bigger trend comes your way.

There are several effective steps you can take to find and jump on opportunities. These include tending your Watch List, scaling your holdings, setting stops, and making a tracking portfolio.

### How to Go About It

Nothing creates more personal investing opportunities than a well-fed, well-trimmed Watch List. Every day you should endeavor to add issues of interest to your list. The best source for your Watch List is ClearStation's filtered lists of issues that are exhibiting excellent price action.

Scale holdings with net worth: The more holdings you have, the more your gains and losses will mirror the major market averages. Limit your holdings to the amount that does not move the stock price itself.

Setting stops and tracking are advanced investing tactics that can significantly boost your investing performance and hone your strategy.

Monitoring issues in your portfolio will tell you if an issue has confirmed your decision. Placing stops automatically limits the damage that can occur when you have made a bad call.

A stop is an order that can be placed with your broker that will automatically execute a trade when a certain price limit has been met. Setting stops, though a very good idea, can be dangerous for highly volatile issues. For example, if the trading range of the same \$10 stock was \$9-11, a stop at \$9 would close you out on ordinary volatility, which tells you nothing about the trend and more or less guarantees a loss. Don't do that. Only place a stop outside of the reasonable volatility of that stock. If you are comfortable trading highly volatile stocks, don't place stops unless you are going on vacation.

In addition to the Watch List, a tracking portfolio can be instrumental in managing opportunities. A tracking portfolio monitors the positions you are pyramiding up: the most successful positions in your investing strategy.

When I create an initial position, I add it to my main portfolio. When it exceeds 10%, I start pyramiding up. When the trade confirmation comes in, I add the position to my tracking portfolio at the new, higher price. If I pyramid up again, I close the position in the tracking portfolio and add it again at the new rate.

The tracking portfolio tells me when the trend is losing steam. It tells me when it's time for my favorite activity: closing winning positions.

## Wall Street Myths by kris

There is a very well-developed mythology that surrounds trading in the stock market. Among the greatest and most damaging myths are

- Myth #1: The Wall Street insiders and professionals have an advantage.
- Myth #2: The real money-makers day trade.

While there certainly was a time when the first myth had some truth, the second is at best misleading. At worst, it is one of the most damaging misconceptions for individual investors to have.

With the advent of the Internet, there is very little information that remains accessible only to the professionals trading on Wall Street brokerage accounts. Though there is a lot of attention paid to analysts who receive early access to company news, their profits are severely limited due to Myth #2.

It is difficult for me to understand sometimes what exactly day traders are doing. They have simply picked another job for themselves, and like any good employee, they are trying to look busy.

The only trends worth following in investing are those that yield returns of 50-500%. Trends like these, though rare, are constantly occurring in the market. They never occur on a daily or hourly basis, but yield their gains in the week-to-month timeframe.

ClearStation finds stocks that are performing in this critical timeframe. By using MACD and stochastic primarily, we cut out the noise of the market to present only a handful of issues every day that are entering week-to-month trending performance.