Market Dynamics

Volume 10, Issue I 1

January 7, 2011

Performance Management System

Stock Market Tides And Noise Traders

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

Ignat's Law

By focusing on the tidal movements in the stock market, the investor can participate in stocks with favorable price trends and end that participation when the trend changes adversely.

A collection of recent newsletters is available on the web site.

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Charles Dow, the founder of the Wall Street Journal, once likened the movements of the stock market to the movements of the ocean washing up on a beach.

There were long-term trends that acted like the tides of the ocean where each successive wave rose to a point higher on the beach than the previous wave as the tide was coming in. At some point the tide would reverse direction and each successive wave would fail to reach as high a level on the beach as the tide was going out. The individual waves represented intermediate trends in the stock market.

He described the minor ripples caused by the wind on the surface of the ocean as the short-term daily variation in the stock price. The short-term ripples in the stock market were later described as noise in the financial system. Noise traders were thought to be those traders who tried to reap profits from trading these minor, unpredictable ripples in he stock market.

As with the weather, at one time the winds can be highly persistent in direction and strength and at other times, the winds can be highly variable with little or no persistent movement. The term "noise trader" implied that these traders were trying to profit by catching a minor breeze in the stock market. The noise in the system tends to make these short-term movements in the stock market unpredictable. The noise trader seems to be in the position of trying to benefit from a very unpredictable aspect of the stock market. The implication by the academic community was that this was an impossible task and doomed to failure.

The long-term investor was trying to benefit from the movements of the tides in the stock market. By focusing on the tidal movement, the long-term investor was offered the opportunity for successful investing. The tidal movements tended to be more persistent than the short-term ripples and the direction of the tide in the stock market could be measured.

The academic community seems to make no distinction between the minor ripples and the tides in the stock market but there is a very important difference. The tides in the stock market offered the hope of participating in a persistent price movement that could not be matched by trading on the noise.

The academic infatuation with the randomness of the stock market seemed to rule out the possibility of a long-term trend. The stock market can be random day-to-day and still experience a persistent trend. The existence of persistent trends in individual stock prices can be demonstrated by examining the histograms of the daily price movements for a large number of stocks. Using a year's worth of data, the majority of stocks showed a distribution of daily price changes with a non-zero mean. The fact that the mean was significantly different from zero implied the existence of a trend.

The problem then seemed to be a question of recording the prices in such a way that the trend would be readily observable. This led to the use of stock charts to measure the trends of stock prices. The trend measurements produced on a stock chart could help the investor decide to participate in that trend and for how long to maintain that participation. The only prediction that needed to be made by the investor was that the participation in the stock would cease whenever the trend changed to an adverse direction.

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