Market Dynamics

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Performance Management System

When The Music Stops

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

Ignat's Law

"These games can be played with great zest and enjoyment, though all the players know that it is the old maid which is circulating, or that when the music stops, some of the players will find themselves unseated."
The General Theory Of Employment, Interest and Money
John M. Keynes

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While I am not a fan of Keysean economic policy, I am a very big fan of J.M. Keynes' description of the stock market and how it works. Keynes was an accomplished investor so he had direct experience with the workings of the stock market. I am most familiar with chapter 12 of Keynes' ***General Theory Of Employment, Interest and Money*** which was titled "The State Of Long-Term Expectations" which was originally published in 1936.

Keynes noted that the willingness to take a chance, which he termed "animal spirits," drives much of the investment process in stocks. He indicated that there might not be much investment if it had to rely solely on "cold calculation."

He also said that casinos should be very expensive and located far away from the average investor. He further stated that "when the allocation of the nation's capital becomes a byproduct of the workings of a casino, the job is liable to be ill-done." That comment seems highly pertinent to the U.S. stock market today that is dominated by hedge funds, high frequency traders. and other activities that are almost indistinguishable from gambling.

He further commented that investing relies on a convention that is believed and relied upon by most investors. That convention assumes that nothing much can happen to a stock's price before the investor can change his bet. This convention is a workable assumption in most stock market environments, but it seems to break down during periods of extreme volatility in the stock market. In highly volatile periods such as 1929, 1987, 2008 and now, a lot can happen to a stock's price in a very short period of time. If a basket of stocks such as the S&P 500 can go up or down 4% in a single day, it must be understood that many individual stocks can experience changes much greater than that in a single day.

It also seems cleat that extreme volatility to the upside is viewed much differently than the same magnitude of change on the downside. Investors are pleased when their stocks go up but they lose sight of the potential for price declines. It should be noted that extreme volatility on the upside will eventually be matched on the downside. A string of highly volatile down days can create a panic in the stock market. This can lead to forced liquidation when the market becomes overly leveraged and a stock market crash is the result.

Chapter 12 is relatively short and, as Keynes noted, it was written on a somewhat different intellectual plane from the rest of the book. The writing is beautiful and the phraseology is extremely colorful. Chapter 12 is a classic and the book deserves a place on every investor's bookshelf.

I will often reread chapter 12 to stimulate my thinking when the market becomes unusually difficult. I rarely come away "empty-handed." I have repeated Keynes' comments about a game of musical chairs because that thought seems especially pertinent in today's stock market.

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