Market Dynamics

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Performance Management System

An Overly Crowded Stock Trade Usually Ends In Disaster

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

Ignat's Law

A gold rush ends ugly."

Mark Twain

"Many a healthy correction has proved fatal."

Old Wall Street aphorism

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A common characteristic of an overly crowded stock trade is that it usually follows an exponential trajectory on the way up. A less well understood characteristic of an overly crowded trade is that they usually don't correct, they collapse. Why does this happen?

It seems that the fad starts out as a reasonable response by investors and traders to the good fortunes of a company. At some point along the way, the fad stock starts to attract traders due to the performance the stock has previously recorded. Their knowledge of the company and its business may be scant and the motivation for their purchase is nothing more than crowd following.

As the end of the fad approaches, the daily share trading volume will approach a peak. The price change is now near vertical and the media coverage that explains the increase in price reaches a crescendo. At some point the relative strength of the fad stock loses its ability to attract new buyers. Insiders and other knowledgeable participants in the upward trend will be made uncomfortable by the very rich valuation characteristics the fad has produced. Many long-term, value oriented investors have already liquidated their positions.

The stock becomes overly saturated by traders whose primary motivation for buying the stock is the relative performance of the stock. This saturation of the stock becomes an increasingly unsustainable condition in the stock. The stock is now vulnerable to any kind of disappointment

Experienced traders will know that the exponential uptrend cannot last forever and they are especially interested in the downside potential for the stock as the fad peaks out and starts down. At this point the upward trend becomes extremely treacherous and investors must be on their guard.

A normal downward price adjustment occurs and it is dismissed by many participants in the stock as nothing more than a healthy correction. They do not respond to this price decline because they expect the stock to recover lost ground and more. The stock may rally back toward the previous peak, but the increased selling causes it to fall short and another down leg begins.

This is where the chart pattern become ominous. The stock has already failed to make a new recovery peak and should the second downward correction make a lower low, many traders will conclude that the upward trend of the fad has turned down. The preponderance of participants in the stock were there primarily because of the upward trend and that has now gone away. It's almost as if a warning bell has been rung and the trend followers now start to sell. As the downward trend proceeds, many trend following traders will now feel an increased sense of urgency to sell their stock.

Many knowledgeable traders and investors now believe that the fad has probably ended and they expect the downside to accelerate. The favorite stock of yesterday becomes an anathema today. At this point many individual investors will be attracted to the stock because they believe the previous price decline has made the stock a bargain. They are unaware of the danger posed by a former fad stock that falls into a downtrend. The usual chart pattern is for the fad stock to drop precipitously and then subside into an extended period of dullness. It may take years to recover the lost ground.

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