Market Dynamics

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A Very Common Mistake By Investors

Performance Management System

Portfolios heavy with under-performing stocks almost never outperform the market.
Ignat's Law

"It is perfectly astonishing how much stock a man can get rid of on a decline."

Reminiscences of a Stock Operator
By
Edwin Lefevre
p250

Attributed to
Jesse Livermore

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

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It seems that investors want to buy stocks that are at bargain prices and this is often a mistake. The investor compares the current price to recent prices and if the stock price has declined the investor concludes that the stock is more attractive today than it was recently when it fetched a higher price. This simple evaluation based on recent price changes often leads the investor to buy stocks with developing problems.

A stock is not a consumer good that has an intrinsic value based on its ability to satisfy a need or serve a useful purpose. Consumers often shop for bargain prices among consumer goods and this behavior is often exploited by merchants through the use of loss leader merchandise and the promotion of sales.

A stock is an intangible asset that primarily produces value for the buyer when it rises in price. It is the increase in price that the investor desires. So why should an investor seek out a stock that is actually declining in price. It seems that the there is a confusion between the behaviors of a consumer looking for bargains and the behavior of an investor seeking a bargain price for a stock.

Wall Street has taken advantage of the bargain hunting behaviors of investors for a long time. They even have a word for it—it is called distribution. Distribution is a sort of wholesale to retail activity where large blocks of stocks are sold to investors on the way down

The lower price today actually indicates that the stock is trading in a downtrend. It may be a serious downtrend that has been in place for some time and shows no indications of reversing. This sets a trap for the unsuspecting investor. He has actually sought out stocks in downtrends to capture a better bargain but the downtrend may reflect a serious problem with financial performance of the business. Persistent downtrends do not happen by accident and they usually reflect problems with the basic business of the company.

Experience shows that, more often than not, Wall Street analysts will recommend the purchase of stocks in downtrends. I have studied the investment opinion changes by analysts closely over the years and many times the rating change from "hold" to "buy" is made while stocks are in a serious long-term downtrend in price. Are the analysts responding to the desires of their customers to buy stocks at bargain prices or are they also driven by a desire to buy stock market bargains. Either way the fact remains that they are calling for the purchase of stocks that are in downtrends. It should come as no surprise that brokerage customers so frequently have a bad experience by following analyst's "buy" recommendations.

Common sense suggests that when a stock gets to be "too" cheap it will stop going down. There are those experienced and knowledgeable investors who follow the stock closely and keep a close watch on developments at the company and in the trading of the stock. I call this group the "inner circle" of a stock and this group includes corporate insiders, market makers, and others close to the company. You can rest assured that they will not let a stock get to be too cheap. When it gets to be cheap enough they will start to accumulate the stock and their buying will create a sideways movement of the price. This sideways movement can be seen on a long-term price chart of the stock and it is usually referred to as a base. Investors looking for genuine bargain stocks should be looking among the stocks with bases. The best time to buy the stock is when it starts to move up and out of the basing pattern on the chart. The stock will then have two things going for it, it is now moving in an up trend and there is good buying support close by. Seasoned investors have learned to seek out stocks that are emerging from a broad base of accumulation.

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