Market Dynamics

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Performance Management System

The Case For Using Long-Term Stock Charts

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The academic community has waged a persistent war against the use of stock charts because the movements of stock prices are random and therefore unpredictable. Has this aggressive attack on stock charts actually helped investors?

First of all, statistical analysis confirms that stock price movements are random. Not only are they random, but the distribution of daily stock price changes can vary from those with extremely positive means to those with extremely negative means. Both types of distributions show the characteristic bell shaped curve but the stocks with a positive mean went up, probably a lot, and those with a negative mean went down, and may have gone down a lot.

Both groups of stocks showed that they moved randomly but the stocks that went up, did so randomly and the stocks that went down, did so randomly. The question does not seem to be that the good stocks that went up, were non-random and the stocks that went down, were random. Randomness does not, in any way, explain why some stocks go down and others go up.

It is the trend of performance of the two types of stocks that are so different. Stocks that go up a lot will show a persistent upward trend of performance on the charts. Stocks that go down a lot will show a persistent downward trend of performance on the charts. The trend of performance needs to be recorded and observed in order to differentiate between the two types of stocks. Long-term investors are better served by holding stocks with a persistently strong trend of performance and avoiding the stocks moving in the other direction. The best way to record the performance of a stock is with a long-term point and figure chart of the stock's relative strength.

The long-term trend of performance can be observed but that does not make it predictable. The investor must understand that genuine randomness precludes the ability to predict the future course of a stock's trend. Prediction would be great, but it is probably impossible.

By recording the trend of performance the investor will know whether the trend is continuing in the direction of the previous trend or not. He may not be able to predict the future trend but he can certainly tell when the trend of performance changes direction and that is almost as good as being able to predict it. As long as a positive trend of performance is maintained, the investor can maintain his participation in that stock. When the trend of positive performance fades away and a new downward trend appears, he will know that the situation has become unacceptable and the participation in that stock can be terminated.

This technique of observing the trend of performance in no way depends upon predicting the future trend of the stock. It does depend upon a willingness to observe the trend of performance shown on the charts. If an investor has been so thoroughly indoctrinated in the idea that charts are worthless, he will be unwilling to use the charts to observe the trend of performance. This is the major disservice that the academic community has produced by their damnation of stock charts.

It seems that many students, who go on to careers in investment management, learn this lesson the hard way and they learn that they have to rely on the charts for an observation of the true trend of performance for the stocks in their portfolios. Some never learn the lesson and they continue to find their portfolios littered with poorly performing stocks and below average portfolio performance.

The distribution of returns for stocks is not fixed and the trends of performance can change at any time. The facts that indicate these trends of performance are unpredictable, actually requires the use of charts to tell when the unpredictable trend has changed direction. To ignore these trends of performance, results in the performance of the portfolio becoming unpredictable and usually unsatisfactory.

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