

The Decision To Buy A Stock

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

Stocks go up randomly and they go down randomly.

What matters is whether they go up or go down.

As a very smart investor once said "stocks going the wrong direction are the wrong stocks to be in"

Burton Crane

Long-time editor New York Times financial section

[A](#) collection of recent newsletters is available on the web site.

Market Dynamics

www.clayallen.com

7325 S. Jackson St.
Centennial, CO 80122

Phone: 303-804-0507

clayallen@msn.com

The decision to buy a stock can be made many different ways but that decision is essentially a prediction that the stock will outperform the market (i.e. go up) for some period of time in the future. Often, the prediction is very loosely framed and it amounts to only a crude hypothesis. It should be understood that a synonym for hypothesis is "guess."

We are talking about guessing about the future of a stock price and it doesn't matter how much we know, or how much we think we know about the stock, it is still a guess. It is very healthy for investors to understand that they are only guessing. If investors realized that they were dealing only with an educated guess, they probably wouldn't be so prone to remain committed to that guess when the evidence from the market proves that they are completely wrong.

The academic community seems to believe that it is terribly important to make your guess based on your knowledge of the company's business. Successful investing, according to the academics, can only be based on this sort of understanding of the fundamentals of a business. It often takes years for investors to unlearn this sort of academic rubbish.

The basic decision to buy a stock implies that it will perform in a certain way in the market. What if it doesn't? What then? The decision to buy was obviously wrong and why should an investor remain committed to such a faulty prediction in the face of direct evidence to the contrary.

The academic community aggressively indoctrinates their students to completely ignore any evidence from the market that might prove or disprove the validity of the hypothesis that led to the purchase of the stock in the first place. The evidence from the market is most often displayed as a historical record of the movements of the stock price on a

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500
FIRST MARBLEHEAD CORP 04/18/2008 3.76 FMD



graph. This is to be completely ignored because stock price movements have been mathematically determined to be random. The predicted movement of the stock price was an essential ingredient of the buy decision in the first place. The only way you can tell if the hypothesis was wrong is by tracking the movements of the stock price over time. If the stock price goes down, even if it goes down randomly, then the hypothesis was obviously wrong.

The factors that went into the decision to buy the stock don't matter very much after the stock has been purchased. The market performance of the stock after the purchase is the only thing that can confirm or deny the validity of the decision to buy the stock.

A declining stock price invalidates all the previous recommendations to buy the stock. Wall Street analysts are fond of saying that a stock has gone down too much and that it must go up because it is too cheap. It should be understood that when a stock gets to be "too cheap" it will stop going down. A stock that is still declining is probably going to get cheaper still.

Long-term charts can be constructed in such a way as to reduce the effects of randomness and to let the true performance of the stock show through. For academics to damn the use of charts is to make suckers out of future investors.

W. Clay Allen CFA