Market Dynamics

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Performance Management System

# The Lesson Most CFAs Never Learn

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

Long-term trends of performance by a stock may be random but they are not accidental nor meaningless.

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**Market Dynamics**

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Most CFAs have been thoroughly indoctrinated with the idea that the movements of stock prices are random and therefore unpredictable. This training usually produces a very strongly held view that stock charts are completely worthless and only fundamental analysis has any hope of adding value to an investor. Once this idea becomes rooted in the CFA's mind, it is hardly ever questioned.

It is widely accepted that the fundamentals of a company will be reflected in the movements of the stock in the market. The reverse proposition is not often appreciated—that the movements of the stock price reflect importantly on the fundamental developments within a company. It seems that many investors ignore stock price movements because they are believed to be random and therefore meaningless.

The belief in the randomness of stock price movements also produces a common belief that all stocks behave the same way. Nothing could be further from the truth. The movements of stock prices are in fact random, but they are also very different. Some stocks show a persistent ability to rise and others show a persistent tendency to decline. Another group of stocks show no persistent ability to either rise or fall and their movements often show a fairly narrow trading range without any semblance of trend movement. All three groups of stocks will be characterized by randomness but their performance in the market can be completely different.

It is also clear that these price behaviors can change at any time. A stock that shows excellent performance in one time period can develop a very negative pattern of movement in a subsequent time period and vice versa. Even though the patterns of performance in the market change, it is not because the price movements are random but because of change. The stock market is not unpredictable because of randomness, it is unpredictable because of change.

There are many factors that go into the determination of a stock price. Some of these factors are real and relate directly to the fundamental performance of the company and business conditions. But other factors may be more psychological and emotional, but important nonetheless. Not only do the factors change but their relative importance can change significantly. The complexity of this process produces a dilemma for many investors, How to keep track of this bewildering and changeable process?

Seasoned investors have learned to use long-term stock charts to glean important insights into how these changes may be affecting a company and its stock price. It is also widely accepted that the changes in the stock price lead the recognition of changes in the fundamentals of the business. The stock charting technique should emphasize the long-term trends of performance by the stock in the market. The long-term trends tend to be more important and show more persistent movement.

A persistent long-term up trend of relative performance may be random but it is also very different from a long-term downtrend of relative performance, that may also be random. Randomness does not distinguish those stocks with good performance from those with bad performance. The very different trends of performance are what sets these two groups apart.

The proper use of a stock chart is to record and measure a stock's performance in the market and to recognize when that trend of performance changes in a meaningful way. Those investors who mistakenly avoid the use of long-term charts to measure performance have needlessly cut themselves off from a source of important insights about the stock. Long-term trends of performance by a stock may be random but they are not accidental nor meaningless.

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