Market Dynamics

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Performance Management System

Distribution—Wall Street's Well Kept Secret

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

about Jesse Livermore

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

http://www.clayallen.com/

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Distribution, as the term has evolved on Wall Street, usually refers to the selling of overvalued stock to the public. It can be thought of as a sort of wholesale to retail function. The breaking up of large blocks of stock and their sale to the public in smaller lots. If these stocks are overpriced, what allows distribution to take place?

At the time the distribution is taking place, it is probably not known or appreciated that the stock is overvalued. This usually becomes apparent only after some time when the deteriorating business performance of the company makes the overvaluation clear. The holders of large blocks of stock always have a more complete understanding of the nature of the business and what is truly going on than the public investor. This seems to be one of the most serious flaws in the efficient market hypothesis.

The public investor is often motivated by a desire to buy cheap stock and that usually means that he is attracted to stocks that have declined in price. It seems that public investors buy stocks the same way they buy paper towels or other consumer necessities. They wait for the item to go on sale. Every merchant knows that sales and "loss leaders" work. Consumers respond positively to the lower prices and investors do as well.

To the individual this seems like sensible and rational behavior. And yet, when dealing in stocks, it seems to be irrational and even a negative, loss producing behavior and yet it is often followed by many investors. The desire to buy a bargain restricts their thinking to a simple comparison of the current stock price to recent prices and if the current price is lower, then it must be a worthwhile purchase.

This is how distribution works and the merchants on Wall Street have taken advantage of this behavior pattern for years. It is amazing that it happens over and over and yet investors don't seem to learn. The selling of large blocks of stock pushes the stock lower and lower but that seems to automatically call forth additional buyers who want to take advantage of the lower prices.

A regular daily report from Market Dynamics reviews the recent changes in investment ratings by Wall Street analysts. Case studies drawn from the TPARC report confirm that it is very common for Wall Street analysts to recommend the purchase of stocks that are going down in price. Some of the subsequent declines that have taken place in those stocks have been astounding. Bargain hunting seems to be the primary behavior that allows distribution to take place on Wall Street.

A few years ago, it took well over a year for the decline in ENRON stock to take place. And yet, day-after-day, many thousands, even millions of shares, were purchased by the public as the stock declined toward a total loss. This experience has been repeated over and over among stocks in the financial sector during the recent bear market.

Investors should learn that stocks that have fallen into a persistent downtrend are probably not a bargain and should be avoided. Trend following seems to be a more rational behavior in the stock market than bargain hunting and it can be easily applied. Investors should remember that "you can't make money in a stock by yourself." In many ways, you will share the experience of the other buyers of the stock. If they have been losing money, then you will probably lose money as well. Trend following does not depend upon sophisticated financial analysis and it can be used by any and all investors to avoid the pitfalls of a naïve "bargain hunting" approach.

Distribution is not some academic theory, it actually happens all the time on wall Street. Bargain hunting is probably the single, most important cause of more losses on Wall Street than any other factor.

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