Market Dynamics

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Performance Management System

Buying Begets Buying and Selling Begets Selling

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

"These games can be played with great zest and enjoyment, though all the players know that it is the Old Maid which is circulating, or that when the music stops some of the players will find themselves unseated."

The General Theory of Employment, interest and Money
John Maynard Keynes

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A friend of mine used to repeat the old phrase about "buying begets buying and selling begets selling." The origins of this idea are lost in time but it still seems to circulate on Wall Street. Is it true and if it is true, how does it work?

It seems that it is true and traders still want to buy the stocks that others are buying and sell the stocks going down. It seems to be less true for long-term investors who often buy stocks that are going down in the belief that they are too cheap. Long-term investors often seem to ignore the trends of stock prices.

There is a tremendous appetite for news and information about which stocks are moving and the media works hard to provide this information. They not only report which stocks are moving but they add explanations for why the move is taking place. They often have to consult knowledgeable members of the investment community for the background stories that explain the movement. This makes them vulnerable to planted stories and misinformation but that seems to be OK because they need these stories fast and there isn't time to verify the accuracy of the information. Some members of the media are considerably more careful about the accuracy of their reports than others.

Experienced traders want to buy stocks that are trending up and sell stocks that are trending down. This is a very natural behavior and it is explained in the book *Influence* by Dr Robert Cialdini. He describes this behavior as following social proof. When individuals are faced with an ambiguous and uncertain situation, they will automatically look around to see what others in the same situation are doing and then do the same. If others are buying a stock, then they must know something I don't, so I will buy it too!. Many times this behavior works well.

Many times over the years, this behavior has resulted in fads, crowd following and extreme movements of prices that look ridiculous and irrational in hindsight. The Dot.com bubble is only the most recent example. Social proof seems to have been a major factor in the development of the bubble in residential real estate. If the primary reason the trader bought a stock is because others are buying it, he must be willing to reverse his position when they start selling it.

However, many times the trader or investor is given reasons for the purchase that appear to be legitimate and mask the real reason for the purchase, social proof. This is the source of much trouble on Wall Street. The reasons for purchase become a prediction about the stock and that results in a commitment to that prediction that make it very difficult to reverse. When the stock stops going up and the trend turns down, the investor remains committed to the prior positive prediction. This is often the source of big losses on Wall Street.

It seems that social proof often works on the buy side but is not followed when the sell decision needs to be made. The investor needs to be on his guard for these situations. This seems to at least partially explain the findings of behavioral finance that deals with investors being willing to gamble with their losses. If investors are following social proof, and they usually do, they also need to follow it when the other investors begin selling.

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