Market Dynamics

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Performance Management System

Randomness and Long-Term Trends of Stock Prices

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

Ignat's Law

The investor should participate in stocks with positive price trends for as long as that positive trend lasts. This does not depend on predictions at all. It depends on observation.

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Many investors believe that because stock price movements are random, that long-term trends do not exist. Nothing could be further from the truth.

It is true that almost all stocks move up and down randomly. This can be easily demonstrated by preparing a histogram of the daily price movements for a stock. The histogram will almost always show a bell shaped, normal curve which is a characteristic of randomness. In fact if a count is made of the up days and the down days, it will usually fall into pattern that is close to 50/50.

When a histogram is prepared for a stock that experienced a strong upward move over a year's time, it will still show a bell shaped curve. The histogram will show a mean that is positive and above zero. The non-zero mean indicates that a positive trend existed for that period of time.

The important point is that stocks can show a strong up trend and still show random price movement. There is nothing about randomness that says a trend cannot exist in the price data. Trends can and do exist in random price data. These trends can be observed in stock price histories. The same is true for stocks that experience strong down trends. A histogram that shows a bell shaped curve with a negative mean.

The belief that randomness precludes a stock's ability to trend is completely mistaken. Strong up trend movement can be observed in about one third of all stocks. Strong downtrend movement can be observed in about one third of all stocks. The remaining third of all stocks show little or no trend movement at all. However, each group of stocks will still show a histogram that is close to a bell shaped curve, so they all moved randomly.

The random movement really means that the future movements of the stock price cannot be predicted. However, since the future movement of the stock price cannot be predicted, the trend of movement can be observed. This is usually accomplished with a chart of the stock's price movements. It is very important for the investor to know when the price trend changes direction.

When the trend changes direction the investor will be able to see that change and act accordingly. A long-term chart can be used to remove the minor and temporary swings in the trend of the stock's price. A persistent change of the direction of the trend is very important information for an investor.

The randomness of stock price movement makes the use of charts absolutely essential for the investor. How else can the investor know that the trend has changed? The investor should be very leery of stock market predictions and he should verify these predictions by charting the trend of price movement. The use of charts is not to make predictions but to continuously observe the trend. The investor should participate in stocks with positive price trends for as long as that trend persists. He should avoid stocks with negative trends until that trend reverses direction. This is not using the chart to make predictions but to find and participate in stocks showing good performance. The investor cannot predict how long that positive trend will last, but he can be confident that when it changes, he will observe that change of direction.

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