Market Dynamics

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Everyone Knows That Stock Prices Are Random

Performance Management System

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

Ignat's Law

Stock prices reflect expectations and lead the actual fundamentals.

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

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There is an old saying on Wall Street that "what everyone knows is not worth anything." That certainly applies to the random movement of stock prices. This has been translated into a mistaken belief that stocks do not trend. Trends in stock prices can be observed for the majority of stocks most of the time.

How the idea of randomness got transformed into a belief that stocks don't trend is a mystery to me. Perhaps the misunderstanding of what randomness really means by most academics is to blame.

The actual history of stock prices shows that many stocks that are trending strongly upward while showing random movement day-to-day. The same is true for stocks trending down but moving down randomly. Random movement says nothing about the stock's trend movement.

To sprinkle in a little mathematical theory. The Central Limit Theorem of Statistics indicates that the outcome of a process that depends on several or many inputs will be distributed normally and the normal distribution will be more closely approximated as the sample size increases. This was well understood by mathematicians at the time Bachelier prepared his PhD dissertation on the random movement of French bond prices. Maybe that is why his dissertation only received "poor marks" and not more substantial praise. Samuelson should have understood these conclusions as well when he used these ideas to discredit stock market chartists.

The professional stock chartist does not claim that charts can predict a random process. The professional chartist uses charts to record and measure the trend of the random process so he will know when it changes direction or strength. The truth is, that he knows he can't predict the future outcome and that makes the use of stock price charts indispensable to observe the trend.

It is enough to know that the trend has changed and act accordingly. The trends of stock prices shown on long-term price charts are much more important than the random squiggles of a short-term chart. The long-term trend provides a better reflection of investor expectations of the future financial performance of the company. Stock price movements reflect expectations and are forward looking. This is why stock prices always lead the fundamentals of a company's performance.

The rejection of stock price charting by many investors has led to substantial losses of capital and much grief. Expectations are what counts and those expectations can be measured with a stock chart. This is the nasty little secret that many investors do not understand. The performance of the stock in the marketplace provides an important insight into expectations of future performance and more importantly, how those expectations are changing.

Everyone knows that charts can't predict but most investors don't understand that stock price charts measure expectations. Those expectations often produce persistent trend movement in stock prices.

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