Market Dynamics

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Performance Management System

How Can Charts Work, If The Stock Market Is Random?

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

Selecting a good stock to buy is only the first step in stock investing.

The most important step is deciding when the participation in that stock should be terminated.

A long-term chart of the stock's performance is essential in step two.

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One of the primary characteristics of a random process is that its outcome is unpredictable. The familiar bell shaped curve of the output of a random process is often used to "prove" that stock price movement is random. It follows that you cannot predict the future of such a process by using a chart of its history.

It is also probably true that the output of the stock market process cannot be predicted by any means, fundamental, quantitative or the occult. The long history of under-performance by professional investors who rely primarily on fundamental analysis seems to make a strong case against fundamental predictions in the stock market.

So what is the investor to do? One answer is to avoid predictions altogether and just buy a broadly diversified market basket of stocks and accept whatever the return might be. However, there is another alternative.

The problem seems to be less of a problem of prediction and more of a problem of participation. Statistical analysis of the movements of individual stocks shows that stock price movements almost always show a normal distribution but many times the distribution of daily changes shows a significantly non-zero mean. A non-zero mean indicates that there was a trend in the stock price data.

The prescence of a trend does not make stock price movements predictable but it does offer a method for selecting stocks to buy as an investment. This method provides an answer to the question of which stocks to participate in as an investment. Contrary to the conventional wisdom, we do not want to buy stocks going down because they are cheap. We want to buy stocks going up because the price trend is up and there is no evidence that it is turning down.

The lesson for investors is that while we can be fairly confident of the existence of a upward trend, we don't know and we can't know how long that trend will last. Do we just buy stocks that are going up and hope for the best? No!

We buy stocks going up and then we monitor their upward trend with a long-term chart of the stock's performance. As long as the trend persists in the upward direction we are comfortable maintaining our participation in that stock. The chart plays an essential role in our decision whether to hold our position or not. We can accept the uncertainty of not knowing how long the trend will last by making sure that if we monitor the trend of performance, we will know when the trend becomes unacceptable.

This seems to be a reasonable tradeoff that allows an investor to accept the uncertainty of not being able to predict the future of the stock price with a more certain decision making rule regarding what should happen when the price trend changes direction. This does not involve predicting how the price movement will develop. It explicitly recognizes that a price trend will probably not last forever and that it can change at any time. In this way, the investor can participate in good stocks for as long as the performance of that stock remains good.

This approach does not deny the randomness of stock price movements and the inherent uncertainty that is always present in investing. It recognizes that the prediction of the future stock price is almost totally impossible. The use of long-term stock charts allows the acceptance of the uncertainty of dealing in stocks but it does require that the investor monitor the trend of performance on the charts and be prepared to act, when and if that price trend becomes unacceptable.

Far from being worthless to investors, long-term charts of performance seem to be essential to the successful outcome of stock investing. It is highly regrettable that so many investors have been so completely misled by the academic community about the usefulness of stock charts to long-term investors.

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