Market Dynamics

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Performance Management System

Stock Charts Measure Trends—They Don't Predict

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

The long-term stock investor should participate in good stocks, for as long as the stock's performance remains good.

Measuring the stock's performance is critical to achieving this objective and that's why stock charts are so important

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The primary reason for following a stock chart is not to predict the future stock price, but to record and measure the trend of price. It is extremely important for the stock investor to know when the stock's price trend changes direction.

It is probably true that the future of a stock price cannot be predicted by any means with any degree of confidence. This is probably true for technical analysis, quantitative analysis and also for fundamental analysis.

Since the future trend cannot be predicted, it is essential that the investor knows when the trend changes direction. The trend may persist for months or even years but it will undoubtedly change direction at some unknown time in the future. The only way to effectively deal with this uncertainty is to record and measure the trend of the stock's price with a chart.

The investor should measure the long-term trend of the stock's price since it is more important. The major moves in a stock's price take time to accumulate and the minor trends result in only minor movements, while the long-term trend produces the major movements. The fact that stock price movements are random says nothing about the existence or the strength of a stock's price trend. Randomness does indicate that the trend is unpredictable and that is what makes the use of long-term stock charts indispensable to an investor.

Given the fact that the future stock price trend is unpredictable, how will the investor know when that trend stops? Assuming that the stock investor buys a stock in an up trend, it is essential for him to know when that up trend stops. When the up trend terminates, the investor will then be able to take profits or stop losses by selling the stock and move the proceeds to a different stock that is still in an up trend. Due to the noise in stock price movements, it is very difficult for an investor to tell when a trend terminates unless he systematically records that price data on a chart.

Another important consideration in the use of long-term charts to measure stock price trends is the fact that trend following works best on stocks with major long-term trends. This should be self-evident, but many investors don't understand that they are invested in stocks that don't trend. These are stocks that either show minor trends or no trends at all and therefore they are investments with only limited profit potential due the lack of trend movement.

A stock that doesn't trend is usually bound up within a narrow trading range. This trading range readily becomes apparent when a long-term chart is examined. Probably at least one third of all stocks are found to exhibit trading range behaviors and these stocks can be avoided by the long-term investor. It is imperative that portfolio managers attempting to demonstrate strong relative investment performance identify and avoid trading range stocks.

It should also be noted that at least one third of all stocks show meaningful downtrends and these stocks should be avoided as well. Too many times, fundamental analysts will recommend the purchase of stocks that are locked into serious long-term downtrends because the decline in price makes them appear to be fundamentally cheap. The trend following investor can believe that the trend will eventually stop going down and the value of the shares will be recognized but he also knows that the stock might go much lower before the trend changes direction. It pays to wait until the change in trend can be seen on the charts.

The remaining one third of all stocks are showing major long-term up trends and these are the stocks that are best suited for trend following using long-term charts. The use of charts quickly narrows the field of potential investments down to the stocks with the best investment potential. This saves the portfolio manager's time and allows him to concentrate his research efforts on the stocks with the best potential returns.

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