

Why Do I Use Charts?

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

**I want the rewards
generated by a strong
stock
and I also want to
avoid the punishments
that follow buying into
a bad stock.**

**That's how we learn
and it completely
shapes our behavior.**

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Market Dynamics
7325 S. Jackson St.
Centennial, Colorado
80122

Phone: 303-804-0507

clavallen@msn.com

So why do I use charts?

Many sophisticated academics, who don't manage investments, tell me that stock charts don't work, in fact, they believe that stock charts can't work. They cite scholarly work that the stock market is random and charts can't possibly work. I use charts because the charts work for me.

First of all, the stock market is a gigantic system of rewards and punishments. Some behaviors are rewarded with monetary gains and other behaviors receive monetary punishments.

To a behaviorist, these rewards and punishments can work powerfully to shape the behaviors of the recipients. When an investor receives a monetary reward, there is a significant increase in the probability that he will repeat that behavior. On the other hand, when a behavior produces the pain of a monetary punishment, the probability shifts and the odds are that the investor will not repeat that behavior.

We are not talking about a purely rational decision maker, we are talking about a decision maker whose behavior is primarily shaped by the desire to receive monetary rewards and avoid behaviors that result in monetary punishments. It is only human nature, its how humans learn. Give us a reward and we will try to repeat that behavior, over and over. Make us suffer with a punishment, and we will avoid repeating that behavior without even thinking about it. We probably can't even describe or understand why we follow those behaviors, but to say that it is rational misses the point. Our behaviors are shaped by our experience in the environment, i.e. the stock market.

I started using charts in my early professional investment management activities because I had a very bad

experience following the advice of several prestigious Wall Street fundamental analysts. I needed a way to avoid the punishments from following faulty Wall Street research. My success as an investment analyst depended on it. Charts seemed to fill that need.

I started to use long-term point and figure charts that I posted by hand every day. My decisions started to improve and I received monetary rewards for following the trends on the charts. I was able to avoid the punishments that the market had in store for me by selling the stocks whose trends turned down. I was also able to buy and hold, for my clients, those stocks whose trends were moving up and I received the rewards for those behaviors.

It is very simple. The market's system of rewards and punishments increased my willingness to follow a rewarding behavior by responding to the trends on the charts. I learned that is how to beat the market. I became a committed chartist because it worked. It produced rewards.

I have seen many stock market fads and bubbles over the years and as Mark Twain said "a gold rush always ends ugly." I have seen Wall Street analysts delude their customers over and over with recommendations to buy stocks of questionable long-term value. I have observed the early indications of powerful new upward trend changes long before analysts could recognize it or write about it.

In short, I have been rewarded and my clients have benefited from my use of long-term charts to measure the trends of a stock's performance. I learned from the market how to receive the rewards and avoid the punishments generated by the fluctuations of the market. It must be understood that the charts don't predict, they can only tell you what is happening now. If the trend indicates that the result is positive then follow it until it changes direction. If the trend is negative, avoid that stock altogether, sell it and don't even think about buying it.

It is simply about rewards and punishments, not predictions.
W. Clay Allen CFA