Market Dynamics

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Performance Management System

Stock Prices Represent Expectations

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

Ignat's Law

"The stock market is a voting machine."

Attributed to

Benjamin Graham

the father of security analysis

It is widely understood that stock prices represent expectations. It is not so widely appreciated that expectations can be influenced by many factors that may have little to do with the fundamental financial performance of the company.

Stock price movements that show up on a chart of the stock price over time provide a record of these fluctuations in expectations. A casual review of stock prices suggest that stock prices move around a lot more than is justified by the changing financial fundamentals of he company. Expectations wax and wane along with the market. This is a natural process and has been evident for as long as there have been organized stock markets.

David Ricardo is best remembered for his contributions to the field of economics, but he was an accomplished and highly successful stock broker and speculator. His son indicated that his father's success was attributed to his belief that the stock market would always overreact to developments. If there was a reason for the stock to go up, it would go up by a large amount. If there was reason for the stock to go down, it would decline too much. This observation was made many years ago and it still appears to be true today.

News of all types has the potential to create a response in the stock market. If fact, the media feels compelled to provide explanations for why a stock moved up or down. They may or may not know the real reason for the price change but they have to provide some plausible explanation for the move. They usually ask their contacts among market professionals why the move took place and sometimes they report these explanations as solid facts without any verification, what so ever. The age of instantaneous communication has been the primary cause for this behavior. They don't have time to check it out, they need to report it now.

Short-term expectations are often completely the result of observations of the recent stock price movement. These expectations can be formed and completely based on the short-term technical analysis of stock price movements. Since short-term technical analysis is highly subjective, there can be a very wide range of opinions about what the price movement really means. This inevitably leads to buying and selling based on conflicting and different interpretations of the same price history. This tends to add to the confusion regarding the true nature of short-term price movements and the expectations that motivated those price changes.

Expectations are not the result of a functional, mathematical calculation. The inputs that affect expectations change all the time and they vary in importance. Expectations can be heavily influence by investor psychology but they are always forward looking. However formulated, these expectations express a belief that something will happen in the future. One side will be proven correct and the other side will have to deal with the mistaken expectations. Benjamin Graham indicated that the stock market is a voting machine and that is an excellent characterization of the price determination process. The changing expectations shown on a price chart are far from worthless, as some academics would have us believe. The charts provide an important tally of the outcome of the voting process in the market.
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