Market Dynamics

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Performance Management System

How Do You Know When A Stock Gets To Be Too Cheap?

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

Ignat's Law

"The people who know what a stock is worth will always buy it when it is selling at bargain prices."

***Reminiscences Of A Stock Operator* by**

Edwin Lefevre about Jesse Livermore

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This is a crucial question for all investors and how it is answered often determines the success or failure of the investment.

The answer for many investors is based on whether the stock is down in price. If it is lower today than the price received recently, it is usually believed that the stock is cheap. If it is down significantly, then it is believed to be an even an better purchase because it must be cheap.

The true answer to the question of whether the stock is cheap or dear, however, depends on future prices and not on past prices. Future prices are unknown while past prices represent a fact. This makes knowing whether the stock is cheap or not very uncertain.

Among the lexicon of Wall Street is the word distribution and the true meaning of distribution is a mystery to many investors. It generally refers to the distribution of large blocks of stock to the public, usually stock that is considered to be overpriced and not a good value. How can this be? Why would the public be willing to buy up stock from holders of large blocks of overpriced stock?

Distribution takes place because of a pervasive behavior pattern among many investors, especially smaller, less sophisticated investors. People are attracted to bargains. They like to make purchases of goods that are down in price. They feel they are getting a bargain. The power of merchandise sales and loss leaders is well understood by most successful merchants. And so it is for the merchants on Wall Street.

Sophisticated investors know that the retail investor is motivated to buy bargains. As the price goes down, many investors feel that the stock is an even better value than it was previously. This allows large holders of overpriced stock to distribute, i.e. sell, their overpriced shares to the public. This usually involves breaking up the large blocks into smaller pieces that can be purchased by retail investors with smaller individual resources.

How do the large holders know that the stock is overpriced? Usually they are within the inner circle of investors that are close to the company and are knowledgeable about the business. Because they have so much at stake, they have a keen interest in the affairs of the company and may be in a position to know privileged information about what is truly going on. Because of their position and contacts, they should be classified as sophisticated investors in that stock. It is only natural for large holders to act to protect their investments, especially when things are turning sour and that knowledge may not be well known or appreciated by the public.

Bargain hunters among the public are looking backward and Wall Street is always forward looking. The investor who is looking backward to find bargains is often on the receiving end of stock distribution. Knowledgeable players on Wall Street take advantage of this behavior pattern every day. This is not a conspiracy to deceive public investors. Public investors deceive themselves with their bargain hunting behaviors, often to their regret.

There is a simple antidote for a bargain hunting mentality. Do not buy stocks that are going down. It is best summed up by understanding that when a stock gets to be too cheap, it will stop going down. As long as it is still going down, it is not too cheap!

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