Market Dynamics

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Performance Management System

No Chinese Wall In Japan

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

Ignat's Law

The trend of a stock's performance in the market is the most important inside information of all. It is available for all to see but you have to look to see it. A long-term chart of performance is the best way to observe the trend.

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The Bloomberg News Service recently carried a story that Merrill Lynch Japan was substantially increasing its research coverage of companies. The story indicated that the Merrill Lynch officer who was quoted in the news story said the increase in analyst's coverage of companies was designed to increase the ability of the firm to attract "merger and acquisition" business.

In the United States it has long been a legal and regulatory mandate that investment banks separate their investment banking activities from their business as a brokerage and proprietary trading business. This has long been known as a Chinese Wall. The press release from Merrill Japan indicates that investment research analysts coverage of stocks will improve their ability to compete more effectively for lucrative investment banking relationships. So where's the Chinese Wall?

Recent legal settlements in the US indicated that investment research analysts were compensated handsomely for their ability to bring in investment banking business. This practice has been suppressed but it has probably only been driven underground. The Merrill Lynch Japan revelation is probably absolutely true but it should not have been revealed quite so candidly.

The whole episode calls forth a question regarding the effectiveness of Chinese Walls in US brokerage firms. The SEC and other regulatory agencies establish rules and guidelines about the use of privileged information in the brokerage business. The rules and regulations do not guarantee compliance. There is so much at stake in terms of monetary rewards that it is probably impossible to eradicate the practice of using inside information in the conduct of the firm's brokerage and proprietary trading businesses. The employees of the firm just learn to cover their tracks and not let evidence of a violation surface.

It seems to be far wiser to assume that the movements of price reflect what is known about the company and its business. Not everyone is privy to the same information and some investors will get the inside story ahead of others. The recent coverage of the Goldman Sachs's "huddles" confirms that to be the case. The portfolio manager who generates orders for stocks 100,00 shares at a time is far more likely to get the privileged information first. This has been confirmed by a recent book written by a Wall Street "all-Star " analyst. The more important traders and investors get the information first.

So what is the average investor to do? He must keep track of the performance of every stock and be alert to changes in the trend of performance. He may not know the reason behind the trend change but the trend change is important information in and of itself. Something caused the change in the trend of the stock's performance and if it persists the investor must act to protect his position. This line of reasoning suggests that the efficient market hypothesis is completely wrong. Some investors have an advantage in their receipt of privileged information and you can bet they will act on it. Their actions create the changes in trend shown on the charts.

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