Market Dynamics

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Performance Management System

Stock Prices And Randomness

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

Ignat's Law

The proper application of stock charting is not to predict the future, but to recognize when important changes in the price determination process have occurred.

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Misconceptions and confusion about the meaning of randomness has caused great harm to many investors. It seems that the majority of investors have been taught to believe that stock price movements are random and therefore meaningless. Nothing could be further from the truth.

Stock price movements have always shown a great deal of noise and random variation that is indeed meaningless. Stock price movements are also influenced by the movement of the overall market. How does the investor remove these sources of meaningless fluctuation to arrive at the specific trends that are affecting that stock?

The point and figure technique of stock charting was developed to damp out the random, short-term, back and forth action in the price of many stocks. The use of relative strength removes the influence of the overall market. A point and figure chart of relative strength gets at the crux of the matter and what shows up on the p&f charts is the true trend of performance that is specific to that stock. This represents a significant improvement over charting the stock price movements against time.

The randomness of stock price movements does not, in any way, preclude a stock's ability to move in trends. The acceptance of the idea of randomness does mean that these trends are not predictable. The process that determines stock price movements is indeterminate and does not follow predefined rules. On the other hand, the trends in stock prices reflect investors expectations about the future trends of major factors that influence the degree of success or failure of the company. Since these trends reflect the expectations of investors, these trends can be subject to wide swings caused by the ebb and flow of investor psychology and other exogenous factors such as governmental regulation and interest rates.

The movements of stock prices in many ways distills these expectations about the future and the result is a gigantic feedback loop. The flow seems to be from business fundamentals to stock prices and from the stock price back into investors expectations about the future fundamental performance of the business.

How does the investor know when important changes are taking place in the company's business? A p&f chart of relative strength can alert the investor to changes that are affecting the business, both good and bad. The proper application of stock charting is not to predict the future of these trends but to gain an insight into the direction and strength of the primary trend. To avoid the use of stock charts because the stock market is random has caused many investors to overlook important changes in this feedback mechanism.

Because the market is always being influenced by noise and random variation, it is very difficult for the casual investor to stay on top of the important and persistent trends which will probably explain the success or failure of his investment portfolio. The misunderstanding regarding the randomness of stock price trends has caused many investors to completely eschew the use of stock charts for any purpose. This leaves them completely vulnerable to unexpected shifts in the fundamentals of the company. A basic familiarity with p&f charts will help minimize those risks.

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