Market Dynamics

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Performance Management System

The Stock Market Feedback Loop

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

Ignat's Law

"Buying begets buying, and selling begets selling."

A bit of Wall Street wisdom.

Source unknown

A collection of recent newsletters is available on the web site.

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It is not widely understood how the stock market feedback system works. To understand the movements of stock prices it is necessary to examine this feedback loop.

The behavior shown by professional traders is to buy stocks that are going up and to sell stocks that are going down. The amateur investor wants to buy stocks that are going down because they think they are getting a bargain. This behavior by amateur investors is due to a lack of understanding of the feedback loop in the stock market.

A stock in a persistent downtrend is providing a feedback signal that investors overlook when they go bargain hunting among stocks. The downward trend in price indicates that the majority of participants in that stock are voting negatively about the stock. They believe that the future financial performance of the company is, or will be, in decline. Sophisticated investors are always looking to the future and their expectations about the fundamental performance of the company will shape their decisions to buy or sell the stock.

The major holders of a stock and the other members of the inner circle know what the downtrend is forecasting. The members of the inner circle surrounding the market for the stock are more knowledgeable about the company and its financial performance and they are probably more sophisticated investors.. The belief that the market is efficient and that all participants in that stock get the same information at the same time and correctly evaluate that information, just does not hold up in the real world. The sophisticated investor knows that the major trend of the stock price is very important. He tends to rely on the signals generated by the major trend of the stock price in the market. He is always alert for indications that the trend may be changing direction or strength.

It is especially important to consider how the financial media tends to reinforce the feedback loop. A stock that is going down in price will call forth explanations for the decline by the media because the media knows that their users want to know why the decline is taking place. These explanations may be delivered as established fact when they are nothing more than educated guesses. It is tempting to classify Wall Street stock analysts as part of the media.

Experience shows that downward price trends are usually more dramatic and volatile than the up trends. It is also true that both up trends and downtrends are the result of a random process. This does not diminish the value of watching the price trends of a stock. A stock's price trend is actually a summation of the votes by buyers and sellers. In order to get the true meaning of the major trend it, is necessary to damp out the short-term noise in stock prices. There are several well established methods for filtering the stock price data to remove the noise. Long-term point and figure charts are a very effective way to avoid being misled by the noise in the price data and to zero in on the true long – term trend.

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