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On Markets

If one believes in a random universe, a strong case can be made for the fact that any sort of technical analysis and trading tactics are in fact quite useless. Under this scenario, random and unpredictable price movements makes research, analysis, and market timing an exercise in futility, and relegates any kind of strategy (other than buy-and-hold) to a game of chance, not skill. As Burton Malkiel famously noted, “A blindfolded monkey throwing darts at the financial pages of a newspaper can select a portfolio that will do just as well as one carefully selected by the experts”. This market view is supported by the fact that the vast majority of mutual funds fail to beat the broader market year after year, and history shows us that the ten best-performing funds in any one year will drop to the bottom of the pack in the following two to four years, meaning that a manager’s outperformance is largely the product of luck, like a gambler’s short-term winning streak. Simply put, there is no way to consistently beat the market.

Needless to say, this view of things does not sit well with Wall Street, which preaches that research, analysis, and relying on expertise are the keys to investing (and their business model!). Assuming that we can draw a similar parallel to other markets, then why bother trading? Why spend so much time researching the market and analyzing prices when we could just as simply close our eyes and buy or sell?

Thankfully for traders, although the random walk theory paints a strong case against mutual funds, it is not entirely bullet-proof. Investors consistently fall prey to fear, envy, overconfidence, faddism, and other recognizably human imperfections that make markets not only inefficient but predictably inefficient. In the short run, recognizable patterns *are* indeed visible in the stock market. Bubbles are created, and then burst. If the DOW goes up one week, it is more likely to go up the next week. In the long run all of these moves smooth themselves out, but in the short run, predicting and trading these constant adjustments can actually make for quite a profitable proposition. Through research and analysis we can visually identify these inefficiencies and market anomalies in charts, and then trade their



Stock market bubbles tend to be of similar length, duration, and size. The chart patterns are similar since the impetus behind them is the same (low borrowing costs, greed, and overconfidence). “This time it’s different . . .”

expected outcomes. The point in trading is therefore not to forecast the future events themselves, but rather to predict and profit from their consequences instead.

The day the financial community realized exactly how imperfect a science it practices was 19 October 1987. On this “Black Monday” US stock markets managed to drop an incredible 22.6% for no apparent reason, which proved especially shocking to the brilliant mathematical minds that had spent their academic careers solving most of the puzzles surrounding proper pricing and valuation. By the late 1980s it seemed that markets had finally been “figured out” and trading was no longer the realm of risk-hungry cowboys as technology quickly came to replace the gut in pricing (and trading) decisions. Yet in light of all this, the world’s biggest and most sophisticated market still managed to shed nearly one-quarter of its value in *one day* and on no news, putting into question even the most basic financial assumptions. By noon of that day, IBM’s stock stopped trading in the face of only sell orders; literally no one wanted to buy. If a stock is only worth as much as someone is willing to pay for it, did this mean that IBM’s stock was, at least for the time being, worthless? What exactly was going on? How could we call the market rational and efficient, let alone figured out?

The fact that this event now seems as distant as the stock market crash of 1929 is evidence of just how much we have moved forward, yet many of the underlying reasons behind the crash are still around today and the trading lessons behind these underline the major differences from what we may call the “academic” view of markets and the trader’s view.

A LITTLE MARKET THEORY

As we know, professors love formulae, and perfect formulae make for perfect markets. The problem with this kind of oversimplified interpretation of the market is that it tends to marginalize an individual’s contribution, while traders realize that sometimes individual actions are actually the driving force behind markets. Why did people sell on Black Monday? It was because everyone else was selling; it is as simple as that.

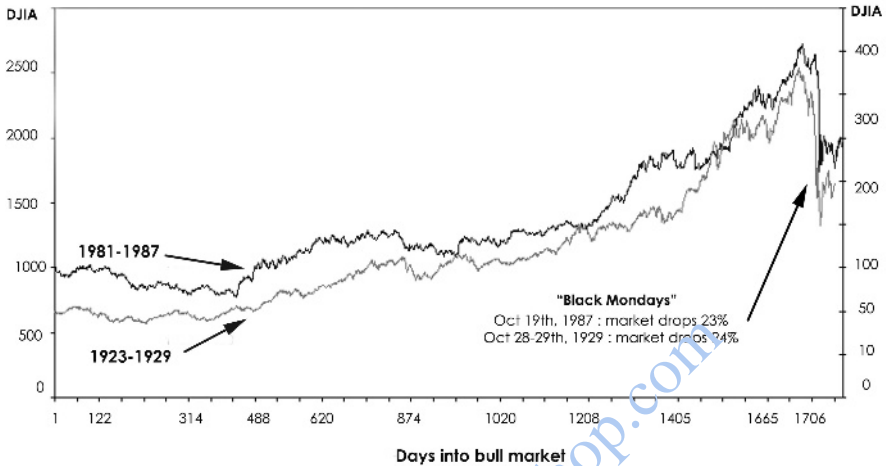
The problem for the academic world is that while real risks (interest rates, stock prices, etc.) are easy enough to understand, *perceived* risks are much harder to quantify and are therefore generally ignored. After all, how on earth can we measure Joe Investor’s sensitivity to risk when on the one hand he spends days researching and analyzing which car to buy and on the other hand he buys Pets.com stock on a friend’s tip?

Over the years traders have learned to get a grasp on this tricky subject, and some interesting things about the perception of risk have emerged. We know that risk tolerance decreases once the market is fully invested, which is why asset bubbles build up slowly and deflate violently. We also know that our brain is hard-wired to shy away from pain and regret, thus making us sell our winning stocks while holding on to losers hoping that they will turn around. How many dead internet stocks do you still have in your portfolio?

What we now know is that markets are efficient, but they are not perfectly efficient. The point where buyers and sellers meet does not always reflect “equilibrium”, and the sheer number of arbitrage-hungry hedge funds out there can be taken as an indication of the market’s imperfection. Since prices are man-made creations that reflect our biases as much as they do economic reality, markets may stay in a state of disequilibrium for a long time when the very reason for buying (prices going up) in turn leads other people to buy.

Those used to doing the day-to-day dirty work in the markets, the traders, dealers, and “locals” in the pit, have all come to realize that at least in the short run, markets are often manipulated and highly irrational. Psychology matters, fear matters. Momentum often trumps economic fact, and we can be fairly certain that as long as there is human involvement in the financial markets they will continue to exhibit the same erratic behavior patterns as human beings. Logic often takes a back seat to greed and fear since at the end of the day it is the trader/money manager that has his job and bonus to look after.

1920's BULL MARKET vs. 1980's BULL MARKET



“A perfect market thinks only of the future, not the past.” The market may not have a memory, but traders certainly do. The eerie similarity between the crash of 1929 and 1987 can probably be attributed to traders in 1987 using the past as a way of predicting the future, unwittingly creating a self-fulfilling prophecy with their actions. (Source: Lope Markets)

Traders that overlook these behavioral aspects end up in trouble when confronted with tumultuous and emotional markets, even if for a brief period of time; hence there is the famous saying, “The market can stay irrational longer than you can stay solvent”. This saying is more true than you can imagine, and the Wall Street graveyard is littered with traders that made money trading rational markets 99 % of the time, yet got wiped out by that irrational 1 %.

Legendary hedge fund manager Julian Robertson found out just how dangerous it can be to fade¹ irrational markets when he rationally shorted the tech bubble of the 1990s and turned his stellar \$22 billion dollar fund into a mere \$6 billion basically overnight. His farewell letter to investors pretty much says it all:

The key to Tiger’s success over the years has been a steady commitment to buying the best stocks and shorting the worst. In a rational environment, this strategy functions well. But in an irrational market, where earnings and price considerations take a back seat to mouse clicks and momentum, such logic, as we have learned, does not count for much.

¹To fade a move is to trade against the prevailing direction. Fading a move higher would mean selling short into the rally.

From a trader's perspective, this means that the market is always right. If irrational investors make a bundle on the way up, while rational investors lose their shirts shorting the move, then who is rational and who is not? Markets are not rational or irrational, they just are, and the only view that traders will ever hold sacred is their need for volatility, because it holds the key to their profits. As long as people are buying and selling, short-term speculators are indifferent as to the rationale behind the moves because they know there is money to be made on both sides of any trade. All that traders care about is maximizing their profits by positioning themselves in advance of the next move, while academics often miss the forest for the trees by being so far removed from the trading floors of the world.

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