What is the Market, Anyway? Defining the Organized Chaos of money-making

By

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Lots of people talk about "the market," but few truly understand what it means? Television, newspapers, and the Internet are mediums where people from many perspectives continually discuss the market. Commentaries present facts and figures on what it will do today, where it will go tomorrow, and how it has historically performed, but nobody can explain how it works. Without a fundamental understanding of how complex the market is, investors are apt to misinterpret the continual flow of new information influencing prices. So, exactly what is meant by this term that gets so much attention?

The reason the market is difficult to define is because it exists only in our minds. Yes, there are multiple physical locations all over the world, but the only place it truly exists is inside our heads. The market reflects our collective hopes, fears, and dreams. It is the ultimate voting mechanism where investors cast votes with their money. It is a unique gathering place where risk-takers can instantly convert an idea into profit on a good idea, or lose on a bad idea. It is cold and objective, and shows no favoritism to anyone. A potential transaction totally depends on what investors on each side of the trade think.

Before a trade takes place, a seller has an idea of the price to expect based on the price of the most recent trade. A seller may think the price is going down, whereas a buyer thinks it is going up. From this perspective, the market is a ubiquitous argument where investors disagree. More sellers than buyers means the price is going down, whereas more buyers than sellers means the price is going up. Besides price, other factors enter the process that further complicates it.

Perhaps Mr. Smith needs cash to meet living expenses in retirement. Even though Smith may believe his stock has good growth potential and is selling at a good price, he sells it for liquidity. Smith also may sell his stock because it has performed well and is dominating his portfolio. Here, his selling decision represents a diversification motive, not a price motive. These non-price factors and many others make it impossible to gauge the direction of stock based on charts. This is one reason technical analysis does not always work. Studies show, however, over time, a security's price follows the company's earnings, and short-term non-price issues disappear.

Several years ago, I observed the trading floor of the Jakarta stock exchange in Indonesia before electronic trading came into the picture. On the floor, chalkboards identifying each stock were arranged in a circle where each board had a big T drawn down the middle of the board. On the left side of the T, a broker representing a seller entered an "ask" price and his initials. The other side of the T was left empty until another broker stopped by and entered a "bid" price and his initials. Each broker made adjustments to the bid and ask price based on their clients' respective interpretation of new information. A trade occurred when the two parties agreed on

price.

When the trading day ended, the two brokers completed the transaction with an exchange of money and paper. Throughout the process, the brokers stayed in constant telephone contact with their clients. The procedure was simple and effective, although time-consuming and labor intensive. Modern electronic trading floors do the same thing using technologies that make the process function much more efficiently.

The result of all this technology is a highly sophisticated trading mechanism that allows investors to consider myriad economic, political and psychological factors when considering a trade. Over the short term, these forces interact in a complex manner that makes it impossible to comprehend what is driving price. Nightly news commentators will tell us what is driving price, but they do not know. Nobody knows! The investor who respects this unsolvable puzzle is not surprised when the price of his/her security does not behave as common sense dictates.

Over time, the probability increases that price will decouple from short-term cross currents and align with long-term earnings: Consistently better than expected earnings reward the stock with a higher price, and disappointing earnings punish the stock with a lower price. Investors who reject irrationally in the short term and insist on making quick transactions in and out of the market play a high-risk game of rank speculation, which is better known as gambling.

Defining the market as “organized chaos” is my definition of the market. What is your definition? Send me your comments at Ron.Copley@gmail.com. I am quite curious to know what you think—it could inspire my next column. LOL

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