E1 Asset Management Says The Perils of Patterns in Investing

The errors our brains make in trying to judge investments. It explains how we are evolutionarily programmed to find patterns, even when they don't exist.

JERSEY CITY, NEW JERSEY, UNITED STATES, May 6, 2021 / EINPresswire.com/ -- Evolutionary biologists tell us that humans are biologically programmed to find patterns in our environment. This skill probably kept our ancestors alive, since those who noticed that water sources were surrounded by green trees were more likely to survive than those who didn't.

Unfortunately, this tendency has developed to the point where we see patterns that don't exist, and that can be disastrous for our investments. Look around you and you'll see lots of people finding meaning in random and probably meaningless information. A couple purchases a few small items and the total comes to $8.88. For the rest of the day, they're convinced that 8 is their lucky number. A man's two children are both born on the same day. For the rest of his life, he buys lottery tickets containing the digits that represent their birthdate.

Meaningless Patterns and the Stock Market
When we apply this pattern-seeking behavior to the stock market, we wind up in terrible trouble. The science of behavioral economics has discovered that even the best investors are prone to a whole collection of mental errors that arise from the way our brains work. A stock's price has gone up for 3 days in a row, so we assume it will rise a 4th day—or, equally irrationally, we'll assume that it can't go up for a 4th day in a row. We associate random coincidences like the length of hemlines and the outcome of baseball games with stock market performance, and then naively presume we can use those coincidences to deduce a law that will predict the future.

It’s not hard to see why this behavior is so tempting. Simple rules are easy to understand and comforting until they fail. The economy is difficult (some would say impossible) to understand and there are no rules that always apply. Much of the market’s performance is controlled by random and totally unforeseeable events, such as Hurricane Katrina. Often, the most we can say is that natural disasters and other random bad and good events will occur, but not where or when they will happen.

Investors do best when they abandon their childish craving for certainty and understand that one is always playing the odds, but that it is possible to do so intelligently. They must also accept the fact that they will sometimes be wrong and lose money, no matter how skillful they are or how much experience they’ve had.

Technical analysis is an entire system based on the belief that there are meanings to be found in seemingly random patters of numbers. Although opinions vary, the foregoing analysis would suggest that it’s completely worthless at best and highly hazardous to your bottom line at worst.

Instead of seeking patterns that point to a sure thing, the key to outperformance is to make calculated bets where the odds are greatly in your favor and to cut your losses as quickly as possible when you’re certain a mistake has been made.

Meaningful Patterns and the Stock Market
Does this mean that there are no patterns that can legitimately be used to predict stock market prices? Not at all. The kinds of patterns that have some predictive value are those that bear a rational relationship to the company’s performance (not to the performance of its stock, although the two should go hand in hand over the long term). Thus, a pattern of steadily increasing earnings is certainly a useful clue to a business with a successful product. Patterns of decreasing debt, steady insider buying, and share buybacks may all predict a winning stock. Patterns of cash burn, unwise acquisitions, and restated earnings may predict the opposite. But even the clearest patterns are never rules—only probabilities.

Conclusion
Knowing what kinds of patterns are meaningful and which are meaningless can improve your investment results and keep you from making disastrous mistakes. Realizing that the stock market is always a matter of probabilities, not certainties, will keep you on the right track.

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