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What's in a Game?

Football is not everyone's favorite sport, nor is it mine. To the non-fans, I apologize in advance and ask that you bear with me for a couple of minutes while I use the game as an analogy to explain an important aspect of the stock market. I begin with a digression.

The stock market illustrates one of the most basic economic theories, supply and demand. These opposing forces or teams are represented by buyers and sellers. Buyers of stock create demand and sellers of stock create supply. In the simplest of situations, buyers of stock reduce the supply of stock sellers have. When the supply of stock is exhausted the price of stock will start to move up. As long as the buyers keep buying, increasing the demand, the price of the stock will continue to increase as the market tries to entice holders of the stock to sell (by offering them a higher price). This process reverses itself from time to time and we find that there are more sellers, or a larger supply of stock, than there are buyers. When this happens, the price of stock decreases in an effort to entice buyers to come to the market and reduce the supply once again.

Now to football. As a rule, you don't put points on the scoreboard unless you have the football. When you have it you can move it over the goal line for a touchdown or kick it through the uprights for a field goal. If your team does not have the football, you are on defense. You try to prevent the other team from moving the ball down the field and you try to get the ball, but it's pretty hard to score points.

When the buyers have the football, demand is in control and prices generally move upwards. At other times, we do not have the ball and there is more selling than there is buying: a greater supply of stock, less demand, and prices go down. Each situation has a root cause such as an economic expansion or a recession, motivating either the buyers or the sellers.

My point, simple enough, is that in stock market investing, sometimes we have the football and can make points (profits), keeping as much money invested as possible. When we don't have the ball and the market is going down, we must behave defensively, protecting profits (defending the portfolio) either by selling or shifting the investments.

Throughout the history of markets--and capitalism itself, for that matter--there have been periods of rising prices and periods of declining prices. In the last 15 years or so, the tools for analyzing the stock market have become more sophisticated and it is easier to recognize shifts in the forces of supply and demand. Time was, when one could just invest in good companies and hold them forever. That is rarely the case now, so I spend a lot of my time watching the football to see which team has it and when it changes hands. This weekend, however, I will be watching the other game and cheering the Patriots on to another victory.