Single Variable Fallacy

For those of us who have invested in the markets for over the last twenty years, there have been rewarding and difficult times. As we ponder over our mistakes they are often the result of a single idea connected to a single stock in which the first will result in the second propelling to a higher level. Why and how would a single variable make an investment profitable?

The fallacy of A being connected to B is a result of our ability for pattern recognition. Pattern recognition in itself has many advantages in the survival of the species. For example, if we notice others crossing the street on a green light – then we will also presume it is safe to cross the street on a green light. Even in this simple example many of you will notice the hazards that await us before we finish crossing the street. Have the cars stopped? Are there still cars coming rather quickly that may attempt to even run a red light? There may be Emergency vehicles that need immediate access to our path etc… Without this pattern recognition it would be unsafe to even venture outside at any time.

In the markets, pattern recognition has been observed by the likes of technical analysts, value investors, quantative projections, and media attention on developing trends in the economy/markets. Pattern recognition is used by business to make sales and profit projections and by marketing groups to sell products to certain groups (either demographic or geographic location). For example most ski equipment will be sold to area's near mountains that receive snowfall and have recreational facilities on them.

Why do we not take the time to search for other variables that may impact a stock price instead of one overriding idea? The most likely culprit is time itself but the more dangerous one is that once we have an idea of how A relates to B we begin to look for support of our idea. Today many people tend to believe that commodity prices are near record highs because of the hot Asian economy. We grant that this idea has much merit but are there not other reasons as well. The major purchaser of Asian manufactured products is the Unites States. A strong economy in the US must also to some degree help push commodity prices higher. Further, certain commodities or products take a number of years to come to the market and is some cases unexpected demand can cause a spike in prices, such as the recent oil market rally in the summer of 2005.

Ho can we benefit and avoid the single variable fallacy? We need to be aware of more factors that affect prices and think about consequences as having further consequences. Just as company profits are not tied directly to interest rates but also need to factor in sales, expenses, the state of the economy, legislation, changing customer preferences to name but a few. A single variable often does not have the impact we may expect it to have. Only by looking back can we notice that a myriad of changes occurred that eventually lead to current stock prices. When looking forward we need to be more aware of the thoughts of others and how their logic may eventually play into the pricing of securities.