# Basic Trading Concepts

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## Random Walk Theory

Before you decide if you want to be a trader, you have to first decide whether or not it's even reasonable to believe that trading can be a profitable endeavor. In order to make that call, you have to choose which basic market theory you believe.

A "random walk" is a statistical phenomenon where a variable follows no discernible trend and moves seemingly at random. The random walk theory as applied to trading, most clearly laid out by Burton Malkiel, an economics professor at Princeton University, posits that the price of securities moves randomly (hence the name of the theory), and that, therefore, any attempt to predict future price movement, through either fundamental or technical analysis, is futile. The implication for traders is that it is impossible to outperform the overall market average other than by sheer chance. Those who subscribe to the random walk theory recommend using a "buy and hold" strategy, investing in a selection of stocks that represent the overall market – for example, an index mutual fund or ETF.

### Basic Assumptions of the Random Walk Theory

1. The Random Walk Theory assumes the price of each stock follows a random walk.
2. The Random Walk Theory also assumes that the movement in the price of one security is independent of price movement in another security.

   One of the main criticisms of the Random Walk Theory is that the stock market consists of a large number of investors and the amount of time each investor spends in the market is different. Thus, it is possible for trends to emerge in the prices of securities in the short run, and a savvy investor can outperform the market by strategically buying stocks when the price is low and selling stocks when the price is high within a short time span.

   Other critics argue that the entire basis of the Random Walk Theory is flawed and that stocks prices do follow patterns or trends even over the long run. They argue that because the price of a security is affected by an extremely large number of factors, it may be impossible to find out the pattern or trend followed by the price of that security, but just because a pattern cannot be found does not mean that a pattern does not exist.

### A Non-Random Walk

In contrast to the random walk theory is the contention of believers in technical analysis, those who think that future price movements *can* be predicted based on trends, patterns, and historical price action. The implication arising from this point of view is that traders with superior market analysis and trading skills can significantly outperform the overall market average.

Both sides can present evidence to support their position, so it's up to each individual to choose what they believe. However, there is one fact, perhaps a decisive one, which goes against the random walk theory: the fact that there are some individual traders who consistently outperform the market average for long periods of time. According to the random walk theory, a trader should only be able to outperform the overall market by chance, or luck. This would allow for there being *some* traders who, at any given point in time, would – purely by chance – be outperforming the market average. But what are the odds then that the *same* traders would be "lucky" year in and year out for decades? Yet there are indeed such traders, people like Paul Tudor Jones, who have managed to generate above average trading returns on a consistent basis over a long span of time.

It's important to note that even the most devout believers in technical analysis – those who think that future price movements in the market can be predicted – don't believe that there's any way to infallibly predict future price action. It is more accurate to say that *probable* future price movement can be predicted by using technical analysis, and that by trading based on such probabilities it is possible to generate higher returns on investment.

So, who do you believe? If you believe in the random walk theory, then you should just invest in a good ETF or mutual fund designed to mirror the performance of the S&P 500 Index, and hope for an overall bull market. If, on the other hand, you believe that price movements are not random, then you should be polishing your fundamental or technical analysis skills, confident that doing such work will pay off with superior profits through actively trading the market.

Since you're reading a book on trading, we'll assume that you fall into the latter camp. We wholeheartedly agree with you. So keep reading...