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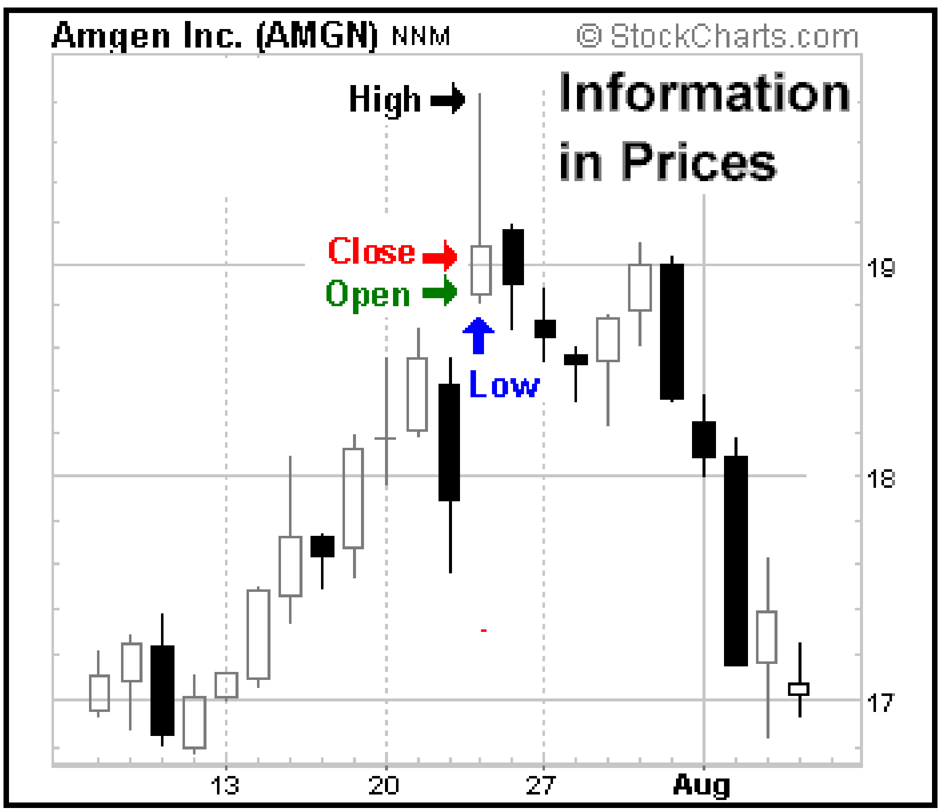
Chart School

Technical Analysis - Part 2

Strengths of Technical Analysis

Focus on Price: If the objective is to predict the future price, then it makes sense to focus on price movements. Price movements usually precede fundamental developments. By focusing on price action, technicians are automatically focusing on the future. The market is thought of as a leading indicator and generally leads the economy by 6 to 9 months. To keep pace with the market, it makes sense to look directly at the price movements. More often than not, change is a subtle beast. Even though the market is prone to sudden knee-jerk reactions, hints usually develop before significant moves. A technician will refer to periods of accumulation as evidence of an impending advance and periods of distribution as evidence of an impending decline.

Supply, Demand, and Price Action: Many technicians use the open, high, low and close when analyzing the price action of a security. There is information to be gleaned from each bit of information. Separately, these will not be able to tell much. However, taken together, the open, high, low and close reflect forces of supply and demand.



The annotated example above shows a stock that opened with a gap up. Before the open, the number of buy orders exceeded the number of sell orders and the price was raised to attract more sellers. Demand was brisk from the start. The intraday high reflects the strength of demand (buyers). The intraday low reflects the availability of supply (sellers). The close represents the final price agreed upon by the buyers and the sellers. In this case, the close is well below the high and much closer to the low. This tells us that even though demand (buyers) was strong during the day, supply (sellers) ultimately prevailed and forced the price back down. Even after this selling pressure, the close remained above the open. By looking at price action over an extended period of time, we can see the battle between supply and demand unfold. In its most basic form, higher prices reflect increased demand and lower prices reflect increased supply.

Support/Resistance: Simple chart analysis can help identify support and resistance levels. These are usually marked by periods of congestion (trading range) where the prices move within a confined range for an extended period, telling us that the forces of supply and demand are deadlocked. When prices move out of the trading range, it signals that either supply or demand has started to get the upper hand. If prices move above the upper band of the trading range, then demand is winning. If prices move below the lower band, then supply is winning.

Pictorial Price History: Even if you are a tried a true fundamental analyst, a price chart can offer plenty of valuable information. The price chart is an easy to read historical account of a security's price movement over a period of time. Charts are much easier to read than a table of numbers. On most stock charts, volume bars are displayed at the bottom. With this historical picture, it is easy to identify the following:

- Reactions prior to and after important events.
- Past and present volatility.
- Historical volume or trading levels.
- Relative strength of a stock versus the overall market.

Assist with Entry Point: Technical analysis can help with timing a proper entry point. Some analysts use fundamental analysis to decide what to buy and technical analysis to decide when to buy. It is no secret that timing can play an important role in performance. Technical analysis can help spot demand (support) and supply (resistance) levels as well as breakouts. Simply waiting for a breakout above resistance or buying near support levels can improve returns.

It is also important to know a stock's price history. If a stock you thought was great for the last 2 years has traded flat for those two years, it would appear that Wall Street has a different opinion. If a stock has already advanced significantly, it may be prudent to wait for a pullback. Or, if the stock is trending lower, it might pay to wait for buying interest and a trend reversal.

Weaknesses of Technical Analysis

Analyst Bias: Just as with fundamental analysis, technical analysis is subjective and our personal biases can be reflected in the analysis. It is important to be aware of these biases when analyzing a chart. If the analyst is a perpetual bull, then a bullish bias will overshadow the analysis. On the other hand, if the analyst is a disgruntled eternal bear, then the analysis will probably have a bearish tilt.

Open to Interpretation: Furthering the bias argument is the fact that technical analysis is open to interpretation. Even though there are standards, many times two technicians will look at the same chart and paint two different scenarios or see different patterns. Both will be able to come up with logical support and resistance levels as well as key breaks to justify their position. While this can be frustrating, it should be pointed out that technical analysis is more like an art than a science, somewhat like economics. Is the cup half-empty or half-full? It is in the eye of the beholder.

Too Late: Technical analysis has been criticized for being too late. By the time the trend is identified, a substantial portion of the move has already taken place. After such a large move, the reward to risk ratio is not great. Lateness is a particular criticism of Dow theory.

Always Another Level: Even after a new trend has been identified, there is always another "important" level close at hand. Technicians have been accused of sitting on the fence and never taking an unqualified stance. Even if they are bullish, there is always some indicator or some level that will qualify their opinion.

Trader's Remorse: Not all technical signals and patterns work. When you begin to study technical analysis, you will come across an array of patterns and indicators with rules to match. For instance: A sell signal is given when the neckline of a head and shoulders pattern is broken. Even though this is a rule, it is not steadfast and can be subject to other factors such as volume and momentum. In that same vein, what works for one particular stock may not work for another. A 50-day moving average may work great to identify support and resistance for IBM, but a 70-day moving average may work better for Yahoo. Even though many principles of technical analysis are universal, each security will have its own idiosyncrasies.

Conclusions

Technical analysts consider the market to be 80% psychological and 20% logical. Fundamental analysts consider the market to be 20% psychological and 80% logical. Psychological or logical may be open for debate, but there is no questioning the current price of a security. After all, it is available for all to see and nobody doubts its legitimacy. The price set by the market reflects the sum knowledge of all participants, and we are not dealing with lightweights here. These participants have considered (discounted) everything under the sun and settled on a price to buy or sell. These are the forces of supply and demand at work. By examining price action to determine which force is prevailing, technical analysis focuses directly on the bottom line: What is the price? Where has it been? Where is it going?

Even though there are some universal principles and rules that can be applied, it must be remembered that technical analysis is more an art form than a science. As an art form, it is subject to interpretation. However, it is also flexible in its approach and each investor should use only that which suits his or her style. Developing a style takes time, effort and dedication, but the rewards can significant.

Written by Arthur Hill

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