

## **Amare Capital Management (Pty) Ltd**

The Efficacy of Support and Resistance Levels in Determining Fair Stock Value



## **Abstract**

Technical analysis is frequently criticized as pseudoscience, akin to financial astrology, due to its reliance on historical price patterns rather than intrinsic valuation models. However, this paper contends that support and resistance (S/R) levels — particularly dynamic ones — serve as empirically valid indicators of supply and demand, effectively approximating a stock's fair value when prices deviate but repeatedly retest these zones. While fundamental analysis depends on speculative assumptions (cash flows, discount rates, terminal growth), S/R levels emerge from real-time market behaviour, offering an observable and actionable measure of equilibrium.

We explore:

- The inherent limitations of intrinsic valuation models.
- How S/R levels function as supply-demand equilibrium points.
- The superiority of dynamic S/R in trending markets.
- The psychological and institutional reinforcement of S/R as a fair value proxy.
- Empirical evidence supporting S/R based trading strategies.

The findings suggest that while fundamental analysis remains crucial for long-term investing, S/R levels provide a more immediate and practical tool for identifying fair value in the stock market.

## **1. Introduction**

### **1.1 Background**

The debate between technical and fundamental analysis has persisted for decades. Critics argue that technical analysis lacks a theoretical foundation comparing it to astrology due to its reliance on historical price patterns rather than economic fundamentals. However, support and resistance (S/R) levels stand out as a unique exception — these zones are not arbitrary but reflect real shifts in supply and demand.

### **1.2 Problem Statement**

Fundamental valuation model such as (Discounted Cash Flow) is highly sensitive to assumptions making them unreliable for short-to-medium term trading. Even if an investor accurately estimates intrinsic value, the market may take years to reflect it in price. In contrast, S/R levels provide immediate, observable reference points where market participants consistently react.

### **1.3 Research Objectives**

1. Highlight the limitations of intrinsic valuation.
2. Demonstrate how S/R levels act as supply-demand equilibrium zones.
3. Compare static vs. dynamic S/R in different market conditions.
4. Provide empirical evidence supporting S/R as a fair value proxy.

## **1.4 Hypothesis**

Support and resistance levels, particularly dynamic ones, serve as a more reliable short-to-medium term measure of fair value than intrinsic models because they reflect real time market psychology and order flow.

## **2. The Flaws in Fundamental Valuation Models**

### **2.1 Sensitivity to Assumptions**

Intrinsic valuation model (DCF) require numerous assumptions:

- Future cash flows (highly unpredictable beyond 3-5 years).
- Discount rates (affected by interest rates, risk premiums).
- Terminal growth rates (small changes lead to large valuation swings.)

### **2.2. Market Recognition Lag**

Even if a stock is undervalued, price may not adjust all other market participants recognize it. This creates a disconnect between intrinsic value and market price (margin of safety).

### **2.3 Behavioral Biases and Irrational Markets**

Efficient Market Hypothesis (EMH) assumes rational pricing, but markets are often driven by sentiment, herd behaviour, and liquidity flows, making fundamentals unreliable in the short-to-medium term.

### **2.4 Conclusion**

While fundamental analysis is essential for long-term investing, it's short-to-medium term predictive power is weak due to model sensitivity and market inefficiencies.

## **3. Support and Resistance as Supply-Demand Indicators**

### **3.1 Static Support and Resistance**

Fixed price levels where buying (support) or selling (resistance) historically dominates. The formation is previous highs/lows and consolidation zones.

### **3.2 Dynamic Support and Resistance**

Levels that adjust with price trends which is more adaptive in trending markets.

### **3.3. Fair Value Reflection**

When price deviates from S/R but retests or breaks these zones, it signals a market reassessment of fair value.

## **4. Empirical Evidence: S/R a Market-Driven Fair Value Proxy**

### **4.1 Order Flow and Institutional Reinforcement**

Larger market participants, such as institutions and market makers, often place significant buy or sell orders near key S/R levels. These zones naturally attract liquidity and tend to repeat as battlegrounds where price is contested and equilibrium temporarily established.

### **4.2 Statistical Backtesting**

Quantitative studies and backtest reveals that trading strategies focused on breakouts and retests around S/R levels can deliver consistent, risk-adjusted returns, particularly when combined with trend and volume filters.

### **4.3 Psychological Anchoring**

Market participants tend to remember past reactions at specific price levels. This memory reinforces future behaviour, often creating self-fulfilling movements that validate the significance of those zones over time.

## **5. Criticisms and Counter Arguments**

### **5.1 "S/R is Self-Fulfilling, Not Predictive"**

While S/R levels do benefit from collective belief, their persistence is largely due to order flow dynamics and algorithmic trading, which rely on liquidity pockets.

### **5.2 "Fundamental Drive Price Long-Term"**

Fundamental value is crucial, but S/R levels help identify where markets begins to recognize that value — providing a tactical edge in shorter timeframes.

### **5.3 "False Breakouts Are Common"**

False breakouts occur, but using dynamic S/R rather than static levels helps filter out noise by adapting to shifting market conditions and trend strength

## **6. Conclusions & Practical Implications**

### **6.1 Key Findings**

- Fundamental models are unreliable for short-term trading due to sensitivity and market inefficiencies.
- S/R levels act as real-time supply and demand zones, making them a practical fair value proxy.
- Dynamic S/R will always outperform static S/R in trending markets.

## **6.2 Practical Applications**

S/R levels can guide entries, exits, and risk management for our traders. Long-term investors may also use them to enhance timing and conviction when fundamental signals align with technical structure.

### **Final Thought:**

Price is the truth. Even if fundamentals justify a valuation, the market must acknowledge it first before it matters. S/R levels provide a map of where that acknowledgement occurs.

### **Human Judgement and Market Sentiment Consideration**

While price action and S/R levels offer a valuable, real-time proxy for fair value, it's crucial to acknowledge that these levels are visible to all market participants. This widespread observability means that they also become focal points for collective sentiments and institutional behaviour. As such, understanding what others may be thinking or anticipating around these levels becomes essential.

Despite being a systematic fund that relies heavily on quantitative models, we recognize that sentiment, management outlook, and corporate actions — such as special situations can provide additional context to explain or anticipate price behaviour at key S/R zones. Monitoring news, earnings calls, and sell-side equity research offers insight into how other participants may interpret these levels.

We do not perform traditional bottom-up business analysis to derive intrinsic value. However, through observing how the market reacts around S/R zones — and layering in sentiment cues, we can infer whether a stock is potentially mispriced or trading near its fair value. This nuanced understanding complements our quantitative framework by integrating selective human judgement in interpreting market narrative.