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TRADING TECHNICAL ANALYSIS

Fundamental vs. Technical Analysis: What's the Difference?

The Two Main Models Used To Improve Your Investing

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making trading decisions: fundamental analysis and technical analysis. While both aim to predict future price movements and identify profitable opportunities, they take very different approaches. Fundamental analysis examines an asset's intrinsic value by examining economic and financial factors, while technical analysis focuses solely on price action and chart patterns.

KEY TAKEAWAYS

- Fundamental analysis evaluates securities by trying to measure their intrinsic value.
- Technical analysis focuses on statistical trends in the stock's price and volume over time.
- Both methods are for researching and forecasting future trends in stock prices.
- Both also have their adherents and critics.
- In practice, many investors combine aspects of both fundamental and technical approaches to inform their decisions.

Fundamental analysis dives deep into a company's financial statements, industry trends, economic indicators, and qualitative factors like the quality of the firm's management and competitive advantages. Practitioners of fundamental analysis believe that by understanding a business's underlying health and potential, they can identify undervalued assets poised for growth.

Meanwhile, technical analysis focuses on patterns and trends gathered from past trading, such as price movements and volume. Technical analysts, sometimes called chartists, use various indicators to predict future price movements. This approach is based on the premise that historical prices indicate market psychology that can predict trends.

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fundamental and technical analysis is crucial for any investor looking to navigate the financial markets well.

What Is Fundamental Analysis?

Fundamental analysis is used in finance to evaluate the [intrinsic value](#)—the real worth—of a security, sector, or economy. It's used when scrutinizing income statements, balance sheets, and cash flow statements for a company's stock. Fundamental analysis is generally for those looking for long-term value.

As such, those performing this kind of analysis are trying to calculate how much the company will make in the future against its present net value. A stock trading below the company's intrinsic value is seen as promising, while the opposite is true for those priced below it. The outcome of the analysis can lead to buying, holding, or selling a security.

The Main Tools of Fundamental Analysis

This approach seeks to uncover the intrinsic value of a security, such as a stock or currency, using these main tools:

- **Financial statements:** These include a company's income statement, balance sheet, and cash flow statement, which provide an economic

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- **Economic indicators:** [Macroeconomic indicators](#) like gross domestic product growth, inflation, and unemployment rates are used to understand the economic environment in which a company operates. These indicators can affect consumer behavior and, therefore, a company's performance.
- **Interest rates:** Central bank interest rates can significantly affect an investment's value. Higher interest rates generally lead to lower stock prices, while lower rates boost stock prices.
- **News and events:** Company news, such as earnings reports, new contracts, and regulatory changes, affect stock prices.
- **Qualitative information:** This includes details about management quality, industry cycles, competitive advantage, and other nonquantifiable factors that affect a company's stock. ^[1]

Investors use these tools to see whether a security is undervalued or overvalued

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Time-consuming: Fundamental analysis requires extensive research and data collection, which can be very time-intensive.

- **Subjectivity:** As with technical analysis, different analysts may interpret the same data differently, leading to the claim that the results end up subjective.
- **Information lag:** Financial reports and economic data are often released with a delay, potentially making the analysis outdated.
- **Difficulty quantifying qualitative factors:** Aspects like management quality or brand value are hard to objectively measure.
- **Assumption of market efficiency:** Fundamental analysis very often assumes that markets are efficient. Hence, long-term value (the prices on the stock market) will eventually match the stock's underlying reality or intrinsic value. However, the long-term may never come, and in the meantime, what's the best approach to obtain the gains from price changes?
- **Long-term focus:** It may not be as useful for short-term trading decisions.
- **Overlooking market sentiment:** Fundamental analysis may not adequately account for investor psychology and market trends. It may miss important price trends and patterns that technical analysis might catch.
- **Vulnerability to unexpected events:** Sudden geopolitical or economic events can quickly render fundamental analysis irrelevant. ^[2]

These criticisms highlight why some investors prefer technical analysis or combine both approaches.

What Is Technical Analysis?

Technical analysis evaluates financial assets, such as stocks, currencies, or commodities, by reviewing the historical price and volume data. Unlike fundamental analysis, which focuses on the intrinsic value of an asset, technical analysis examines the volume and price of shares over time. ^[2]

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exploited for potential profit.

Important: Fundamental and technical analyses are the major schools of thought for approaching the markets.

The Main Tools of Technical Analysis

Here are the tools most often used in technical analyses:

- **Technical analysis indicators:** These are mathematical calculations based on price, volume, or [open interest](#) to predict future prices. The indicators are generally based on momentum or mean reversion.
- **Volume analysis:** This studies the number of shares, lots, or contracts traded in a security or market during a certain period.
- **Relative strength:** This metric compares the performance of an asset to a benchmark to gauge its momentum. ^[2]
- **Chart pattern analysis:** The study of price movements in a market pinpoints patterns that can suggest future activity. ^[3]
- **Candlestick pattern analysis:** This kind of financial chart used for price movements could indicate investor sentiment, market trends, or reversals of those trends. ^[4]



Example candlestick pattern

A candlestick pattern on charts consists of rectangular "bodies" that show the opening and closing prices, with thin vertical lines called "wicks" or "shadows" extending above and below to indicate the high and low prices for the period. The body is typically colored differently (often green/white for up moves and red/black for down moves) to quickly convey whether the price closed higher or lower than it opened during that time frame.

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- **Support and resistance:** These are horizontal lines drawn on a price chart to indicate where a security's price will be unlikely to move beyond. ^[5]
- **Trend analysis:** This is interpreting past and present moves in the market to predict future asset prices. Historical prices and trading volume are the most

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Criticisms of Technical Analysis

Trying to predict stock prices based on past trading data has long been a topic of heated discussion, with many academics and professional investors being skeptical about its effectiveness. Imagine trying to predict tomorrow's weather just by looking at past weather patterns. That's somewhat akin to what technical analysts do with stock prices.

Skepticism of the Efficiency of Markets

One of the main criticisms of technical analysis is that it goes against the [efficient market hypothesis](#).^[7] This economic theory suggests that stock prices already reflect all available information, making it impossible to consistently beat the market using any predefined strategy. Critics argue that even if technical analysis really worked, everyone would use it, and its advantages would quickly disappear. However, proponents of technical analysis counter that markets aren't always perfectly efficient, and that there's value in analyzing price trends and trading patterns.

Supposed Non-Objectivity of Technical Analysis

Another point of contention is the often subjective nature of technical analysis. Much like seeing shapes in clouds, different analysts might interpret the same chart patterns differently, leading to inconsistent predictions. Moreover, with so much financial data available today, there's a risk of "[overfitting](#)," or finding patterns that seem meaningful but are actually just coincidences --similar to how you might flip a coin 10 times, get heads each time, and mistakenly conclude the coin is rigged. This has led to concerns about data mining, where patterns that seem to have worked in the past have no real predictive power for the future.

Despite these criticisms, technical analysis remains popular among many traders and investors. Some argue that technical analysis may appear to work in some cases due to a [self-fulfilling prophecy](#): if enough traders follow the

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might gain insights into the emotions driving buying and selling pressure, which can be valuable for identifying [resistance and support levels](#), and timing entry and exit points in trades.

The debate continues, with ongoing research determining if and when technical analysis can be effective. For now, the jury is still out, and investors are left to decide for themselves whether to incorporate technical analysis into their strategy.

The Pros and Cons of Fundamental and Technical Analyses

The table below provides the pros and cons of fundamental and technical analyses.

Fundamental Analysis

Pros

In-depth understanding: Fundamental analysis provides a comprehensive understanding of a company's financial health, including its income statement, balance sheet, and cash flows.

Long-term focus: It is particularly useful for long-term investment strategies since it tries to determine an asset's intrinsic value.

Risk mitigation: By analyzing a company's financials and market position, investors should better assess the risks associated with an investment.

Qualitative factors: Fundamental analysis considers factors like management quality, brand value, and market

Technical Analysis

Pros

Timely: Technical analysis allows for real-time decisions based on the price and volume data.

Simplicity: It often uses graphical representations, making it easier to follow than complex financial statements.

Risk management: Tools, like stop-loss orders, can be implemented after using technical analysis to figure support or resistance levels.

Psychological insights: Charts can reflect market sentiment, providing a quick view of the psychology of

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Adaptable: It can be applied to various asset classes, including stocks, currencies, and bonds.

Cons

Time-consuming: Fundamental analysis is labor intensive, requiring a deep dive into financial statements, market trends, and economic indicators.

Short-term inefficiency: It may not be as useful for making short-term trading decisions.

Subjectivity: Qualitative factors are often subjective and can vary from one analyst to another.

Market irrationality: The market does not always reflect the intrinsic value of a stock, especially in the short term.

Information overload: The abundance of economic, financial, and other data can be overwhelming and may lead to analysis paralysis.

Adaptable: It can be used for asset classes like stocks, currencies, and bonds.

Cons

Self-fulfilling: Popular indicators may influence investors to make similar decisions, skewing the market.

Noise: Short-term fluctuations can generate false signals.

Subjectivity: The approaches, patterns, and indicators can be viewed differently depending on the analyst.

Lack of fundamentals: Technical analysis generally ignores the underlying financial health of assets and focuses on historical price patterns.

Information overload: The abundance of indicators and patterns can lead to analysis paralysis.

Fundamental analysis is a valuable tool for long-term investments but is less adaptable to short-term moves.^[8] It offers a balanced approach by considering qualitative and quantitative factors, although interpreting them can be subjective. Alternatively, technical analysis provides a quick, visual way to evaluate assets, but it too has limits. Traders and investors often used technical analysis with other methods for a more comprehensive strategy.^[9]

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strengths of both to compensate for their weaknesses. ^[8] ^[9]

To begin a blended approach, you might initially gauge the intrinsic value of an asset through fundamental analysis. This involves evaluating financial statements, market trends, and other qualitative and quantitative factors. Later, technical analysis can be used to identify the best entry and exit points. This involves studying price charts, patterns, and other market indicators.

This approach provides a more complete understanding of an asset or market. It combines the fundamental analysis's risk assessment capabilities with the technical analysis's timing. Thus, it can be suitable for short- and long-term investment strategies.

However, blending fundamental and technical analyses requires a good understanding of both, making your work time intensive. The need to master these two different types of analysis could be overwhelming for some.

Nevertheless, the blended approach is balanced, offering the depth of fundamental analysis and the real-time applicability of technical analysis.

Who Is Benjamin Graham?

[Benjamin Graham](#) wrote two seminal texts in the field of investing: “Security Analysis” (1934) and “The Intelligent Investor” (1949). He emphasized the need for understanding investor psychology, cutting one's debt, using fundamental analysis, concentrating diversification, and buying within the margin of safety.

Who Is Charles Dow?

Charles Dow is perhaps best known for cofounding Dow Jones & Company and developing a set of principles that came to be known as Dow Theory. This work laid the groundwork for technical analysis in financial trading. The theory posits that market price changes reflect all available information—he considered

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How Can Quantitative Analysis Be Incorporated Into Fundamental and Technical Analysis?

Including [quantitative analysis](#) in fundamental and technical analysis could inform a multifaceted investment strategy. Synergies include multifactor models where the combination of fundamental and technical factors in one model can be used to predict stock returns. Also, quantitative techniques could be used to balance a portfolio based on fundamental and technical criteria. ^[10]

How Can Fundamental and Technical Analyses Be More Robust?

Improving the robustness of fundamental and technical analyses involves a more all-encompassing approach. This includes ensuring that the data used for the analysis is accurate and updated. Also, machine-learning algorithms could be used to identify patterns that traditional methods could miss. Rigorous [backtesting](#) could also help validate when your strategy is effective.

You can also assess how sensitive your models are to changes in assumptions, and you can update your models to adapt to market changes. Using these practices, you can make your fundamental and technical analyses more robust, adaptable, and representative of the market's complexities. ^[1]

Which Is More Important, Fundamental or Technical Analysis?

The debate between the importance of fundamental and technical analyses in investment decision-making is long-standing and nuanced. Both approaches offer important perspectives and are more or less valuable in different contexts.

The Bottom Line

Fundamental and technical analyses serve as critical tools for those in the market. Fundamental analysis focuses on financial statements and economic indicators to assess an asset's intrinsic value, making it more suitable for long-term investment decisions. Alternatively, technical analysis examines share

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Many investors and traders opt for a blended approach, leveraging the strengths of both. As it's often pithily put, fundamental analysis provides insights into what to buy, while technical analysis tells you when to buy or sell. Ultimately, the choice depends on your trading style, investment horizon, and financial objectives.

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