

Fundamental Vs. Technical Analysis

Both Are Important For Traders

Fundamental and technical analysis are two methods aimed at arriving at a common goal: when to buy a company's stock. However, the two methods have vastly different approaches. Fundamental analysis considers the company's valuation which ultimately depends upon the value of the Company's assets and the profits they can generate with invested capital.

With fundamental analysis, we are concerned with the difference between a stock's "fair value" price and the price at which the stock is trading. A stock trading below fair value is trading at a discount, and, according to fundamental analysis, the price should increase towards that value.

Technical analysis on the other hand, is concerned with short-term price actions. That's because a stock's price and trading volume give clues as to the stock's supply and demand dynamics, creating momentum in a stock's price that can cause it to deviate from the "fair value" determined by fundamental analysis.

Starting With Fundamentals

Fundamental analysts consider a company's financial positions and performance by assessing the company's financial statements, including the income statement, balance sheet, and cash flow statements.

These statements help calculate ratios and metrics reflecting the company's performance. Industry data and economic factors such as interest rates and consumer spending are also used to forecast future growth rates.

These assumptions are critical because a stock's value is derived by the value the company can produce in the future. So if an analyst may create a complex financial model with different forecasting parameters, but a model is only as valuable as the underlying assumptions. If assumptions are wrong, then the fair value will also be incorrect.

There are additional limitations with fundamental analysis.

- Short term price movements and volatility cannot be forecast by looking at financial statements, the march towards a stock's fair value is a lot less precise than many would think.
- Target valuations can be useful on a relative basis, but they are limited when valuing a company more than one or two years into the future because things change fast in corporate America and in financial markets.
- Analyzing a company is also extremely time consuming and most of the information is widely accessible which means everyone is analyzing companies and trying to determine their fair value. In order to gain an edge with fundamentals, you need to find unique datasets or perspectives that make bold assumptions that are contrary to the general investor consensus.

Onto The Technicals

Technical analysis can be pretty simple, but it's also the rabbit hole that has produced some of the most sophisticated algorithmic trading strategies in the world. Apart from analyzing price charts - typically the romanticized life of a Wall Street analyst - the tools used can vary widely and get extremely mathematical.

Some analysts use indicators like moving averages and oscillators calculated from stock prices. Others use price patterns, and complex analysis frameworks like Elliott Waves and Market Profile in order to identify short-term price trends and evaluate investor momentum to determine when a stock's price may take a turn.

Another major advantage of technical analysis is that stocks can be analyzed quickly, with many automatable processes which allow investors to analyze a broader array of companies. Technical analysis can identify price targets and price levels which offer a stock resistance and support prices at which traders can time their entry into the market.

Another benefit? We can backtest our investment strategies with old market data, which is how the first algorithmic trading systems started.

So Which Is Better?

It's a trick question. By searching for an answer to the question of whether fundamental or technical analysis is better, we run the risk of misunderstanding that both are useful tools in an investor's arsenal.

Fundamental analysis is most useful for long term investments, while technical analysis is more useful for short term trading and market timing, where price movements are determined by supply and demand. Market sentiment and the effect of emotion on market activity can only be analyzed by using price and volume data.

For many investors, chart reading is often regarded as more an art than an exact science. For instance, charts cannot be used to determine whether a stock is under or overvalued and what its value may be years into the future. Charts reflect what has happened in the past, and their value diminishes the longer the time horizon. That's where having a strong understanding of fundamental analysis is essential.

Fundamental analysis can guide investors towards fair value: what the company is actually worth. And from there, the logic is simple: find stocks trading at a price below their fair value and buy them. But markets do not always behave rationally, which is why technical analysis can shed some light on why a stock's price may temporarily be higher than fair value.

A Marriage Of Techniques

There are several ways in which technical and fundamental analysis can be used effectively together. Quantitative studies have found that a combination of value and momentum can be an effective method of stock picking. In simpler terms, stocks trading on low valuations but with strong momentum tend to outperform the overall market.

Technical analysis helps determine favorable entry levels for growth stocks experiencing an uptrend. Companies with higher growth rates typically trade on high valuations which makes them susceptible to higher volatility and price corrections. In such cases, technical analysis can be used to identify oversold levels and highlight the best times for an investor to buy.

Stocks can continue trading higher long after they become overvalued. Selling a stock just because it is expensive often means missing out on a large percentage of a rally. By using price and volume trends you can continue to hold the stock until momentum is exhausted.

At the end of the day, technical analysis can be used to confirm anticipated trends, but the fair value that you use to determine if a stock is overbought or oversold comes from fundamental analysis. That's why, in the future, the debate over the 2 styles of analysis may become immaterial as multiple approaches are combining quantitative, qualitative, and systematic approaches to investing.