TA 101 - Part 2 [ChartSchool]

stockcharts.com/school/doku.php

Table of Contents

TA 101 - Part 2

This is the second part of a series of articles about technical analysis from a new course we're developing. If you are new to charting, these articles will give you the "big picture" behind the charts on our site. If you are an "old hand," these articles will help ensure you haven't "strayed too far" from the basics. Enjoy!

(Click here to see the entire series.)

The Value of Technical Analysis

The reason technical analysis has value is that directional price moves are often sustained for a period of time allowing analysts to detect and profit from the change in price. Even though a technical analyst has many math-based tools to analyze price and volume movement, the process is ultimately an art in the study of human behavior.

Just as the meteorologist can never guarantee a weather forecast, a technical analyst can never be perfectly certain of future price movements since human behavior is involved.

Figuring out the what and when...

All investors are faced with three basic questions with their investments. What to invest in, when to buy and when to sell. Technical analysis provides a framework for investors to methodically select equities and pick times to buy and sell. Emotion, the investor's nemesis, is greatly reduced in these decisions since the investor can develop a list of "what and when" rules to follow. Rather than "buying and hoping for the best", technical analysts always know how much risk they are taking and know when to "get out while the getting is good".

Only price and volume only...

Only historical price and volume data is used for technical analysis. The underlying premise of technical analysis is that all known information such as what a company does, its financial results, analyst's ratings, management performance, politics, news, etc. are reflected in the historical price and volume data. This is a powerful concept since it is impossible to gage how these factors may influence future price separately.

It is important to understand technical analysis can only be used to determine the likely direction of future prices. It cannot anticipate news events or how investors will respond to them.

The Goal of Technical Analysis

The graph above is a historical price chart for the company Analog Devices, Inc., ticker symbol ADI. The line represents the price of ADI over a period of a year. The price chart illustrates how prices can move up, down or sideways for months at a time. Technical analysis uses methodologies to help indicate when prices are beginning to change direction. The goal of a technical analyst is to buy an equity when the price chart indicates prices are beginning to move up and then sell when the price chart indicates prices are beginning to move sideways or down.

Why Technical Analysis Works

Technical analysis works because price and volume often reveal the collective psychology (the “fear/greed balance”) of a market's participants. Technical charts can reveal changes in the fear/greed balance soon after those changes occur and that provides opportunities for profitable trades. Technical analysts work to identify charts where the fear/greed balance has recently changed in a predictable manner. They then place trades to try and profit from that change. Once they have bought a stock, technical analysts monitor price and volume for sell signals. Done correctly, trades based on technical analysis carry a higher than average chance of success but disciplined money management techniques must still be used to guard against unforeseen price movements.

Misuse of Technical Analysis

While the basics of technical analysis are easy to learn, applying them correctly and successfully isn't easy. Because of this many people have lost money using technical analysis techniques and then concluded that chart analysis has no value. In addition, unfortunately, many unsuspecting investors have purchased technical “systems” that promise outlandish returns for little effort. By the time the buyer figures out that the system doesn't work, their money is long gone.

Technical analysis is just like any other money making occupation - it takes time and energy and it involves risk. Anybody who says otherwise shouldn't be trusted. Here are ways technical analysis has been misused in the past:

The Holy Grail mentality...

One of the most common misconceptions about technical analysis is that a trading system (a set of buy and sell rules) can be devised that provides consistent profits with little to no risk.

There are several reasons that a “perfect system” cannot be sustained. Firstly, the market is made up of people with free will and guided by fear and greed. A perfect system requires prices to consistently move in predictable patterns. This will never be possible when people are involved. Secondly, many financial institutions monitor the market for patterns of systematic trading. Once detected, the financial institution can take advantage of the system (investing with or against it) which eventually compromises and defeats the “perfect system”. And finally, what motivation could someone have to share a “perfect system” at any price? Such a system would be invaluable to one person but worthless (for the second reason) if too many people or even one institution discovered it.

Just tell me what to buy...

Investment charlatans and gurus have always been offering advice how to profit in the market. These are the people who take financial advantage of new and uninformed investors by promising quick and profitable investment success. Claims of ultra-high rates of return or knowledge of future events for substantial fees are the best ways to identify such schemers.

Although a real guru is a spiritual guide or teacher, the title “Market Guru” is gladly accepted by advisers who have developed notoriety with fortuitous calls of major market changes or unusual approaches to investing. Today's TV media and the Internet enthrone new market gurus on a regular basis. There are precious few true market gurus like Warren Buffet who have proven their market savvy over decades. Most market gurus can only provide profitable guidance as long as the market is favoring their investment philosophy. As the market changes, new market gurus will emerge as their philosophies' agree with the new market dynamics.

Technical Analysis lets me control the market...

While few people consciously believe that they can control a stock's price directly, subconsciously, chart analysis can give new investors a false sense of control, which will cause them to lose objectivity: “My stock just broke below my trend line today, but it will come back tomorrow since that is a really good trend line!”

The opposite response is just as damaging: “My stock broke my trend line! T/A is worthless!” Both responses are driven by emotion, something that technical analysis strives to eliminate.

Next time, we'll take a critical look at the assumptions that technical analysis makes about the markets.