Why Technical Analysis Matters

Michael Kahn

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To start with, technical analysis is a bit of a misnomer since it's not that technical.

Sure, there are some complex mathematical concepts tied to it. But at its core, technical analysis, also known as stock charting, is simply a method of determining if a stock or the market as a whole is going up or going down. Once we identify these trends, and that is something we can do by simply looking at a stock chart, we are way ahead of the game with regard to assembling a winning portfolio.

As a technical analyst, this is how I approach the markets in "Getting Technical," my twice-a-week column on Barron's Online.

Like other technical analysts, I use data generated from the stock market and from the actions of people in the market. Such data includes the amounts of stock being bought and sold each day, the rate of change of price movements (momentum) over a given span of time and analysis of price levels that have served as turning points in the past.

For example, if a price of $50 for a stock brought out the sellers on one or two occasions in the recent past, this price level is considered to be "resistance," where the supply of stock increases relative to the demand. People think it is expensive so they attempt to sell. Simple economic theory suggests that prices will stop going up, if not actually decline.

Technical analysis also attempts to measure the collective investor psyche, calling heavily on the psychology of crowds and the cycle of greed and fear. If everyone thinks one way, the odds that the market thinks the other are usually high.

Contrast that to the more ephemeral fundamental analysis, the standard analytical backbone of Wall Street for several generations.

Fundamental analysis, which seeks to uncover the intrinsic or true value of a stock, is dependent on future sales, earnings and cost estimates of a company being studied. Often, these numbers change as circumstances, such as the overall economy or the competitive landscape for a company, change.

By contrast, the inputs of technical analysis -- the price of shares and the volume being sold -- never change after the fact. Charts are never revised later.

This is not a knock on fundamental analysis, which was made famous by men like Graham, Dodd, and even Buffett and can be quite useful in determining the health of a company. Rather, it is a statement that the opinion of the market itself (through the hard facts of stock-price movements) is very important for making an investment decision and should not be overlooked.

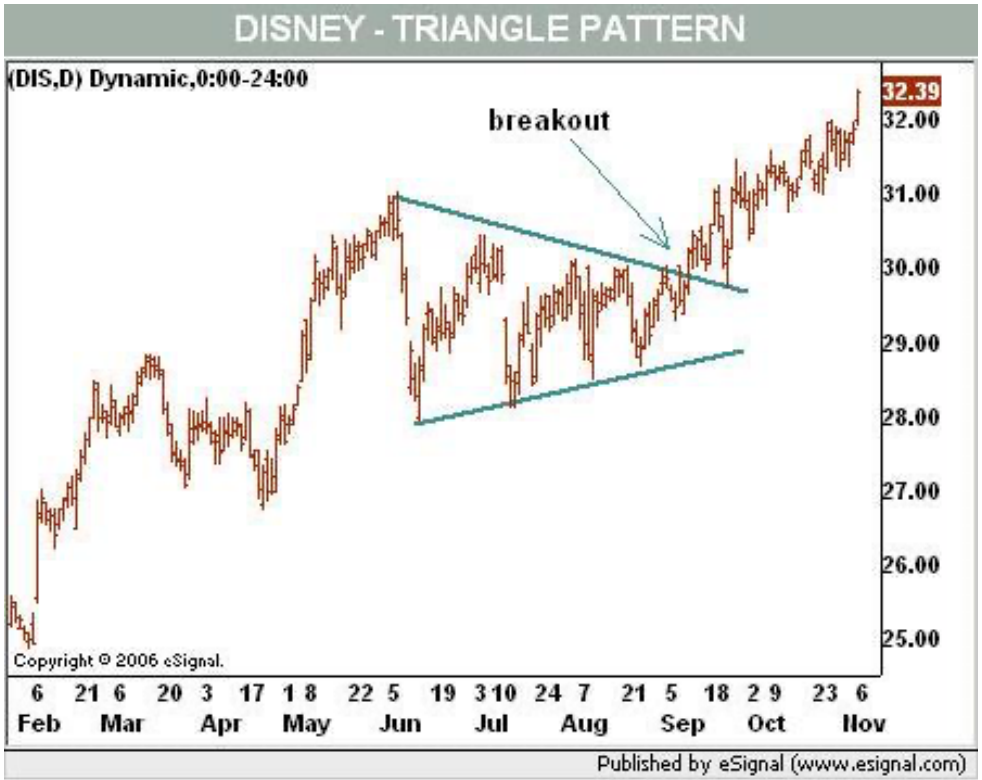
How it works

Critics will point out that forecasting future price movement based on past price movement is akin to reading tea leaves or divining the future from the textures of chicken entrails. Many of the high priests of fundamental analysis are quick to call technical analysis the financial world's alchemy.

Indeed, chart watchers cannot predict the future any better than your broker, your spouse or a Ouija board.

But what they can do better than most is make a decision about what to do -- buy, sell or hold -- based on the probabilities of the actions of others given certain conditions. In other words, if a pattern on the chart appears, a chart watcher can create a framework for what the market might do if and when prices break free from that pattern. It does not work every time, but past performance does give us an idea of what will happen so we can do something about it.

For example, if a stock is rising and then starts to move sideways as bulls and bears become uncertain as to what to do next, a coiling pattern appears on the chart as price swings in both directions diminish (See Chart.) Chart watchers might label it as a "triangle" pattern simply because that is how it looks on the chart.



Typically, when such a pattern appears after a reasonable trend it represents a resting period. Chart watchers wait for prices to move above the upper border of the triangle and then buy the stock because the odds favor further gains. Why? Because such an event represents a shift in the market where a price range that was once considered to be expensive is suddenly considered to be cheap. We do not have to concern ourselves with what happened to cause that change in opinion specifically but only that it did happen.

But even with such a breakout from the pattern, chart watchers do not know for sure that the stock will go up, and they do not know how long it might take. What they do know is that the probability of making money by owning the stock is good.

Since chart watching is not infallible, an even more important aspect is that it will tell us quickly if our assessment of the market's mood is incorrect. For example, if prices move higher from the triangle pattern in the chart and then fall back within that pattern, we will know that we were incorrect in our original decision to buy. Either we missed something on the chart or the market simply changed its mind and decided to go down. We sell immediately and book our small loss, leaving our egos at the door.

Something chart watchers keep pasted to their computer screens is a sticky note that says. "All big losses begin as small losses." When the initial reason for buying is gone we don't hang around hoping it will go back up. Hope is a four-letter word in the world of investing.

If a chart watcher follows breakouts, he or she will inevitably have losing trades. But it he or she is disciplined and responds to breakout failures, the losses will be small and easily overwhelmed by the profits from winning trades.

Recent changes in charting

Chart watching can trace its roots back more than 200 years to Japanese rice trading. Charles Dow, a forefather of modern technical analysis and a co-founder of Dow Jones & Co., the parent of Barron's Online, made his ground-breaking observations in the late 19th century.

Analysis was done with paper and pencil for decades until personal computers made their appearance and with computers, the sophistication of the analysis blossomed.

Over the past 20 years or so, charting has spread from a few Wall Street analysts with access to price and volume data to the mainstream. With the explosion of trading activity by individuals in the 1990s, the markets became incredibly liquid and technical analysis was perfectly suited to take advantage of the activity. But as computer power became cheaper and websites offering free tools and cheap trade execution became prevalent, market volatility soared.

Price movements that previously occurred over periods of months were occurring weekly and this required chart watchers to adapt their tools to the new market paradigm.

Whereas price patterns or ranges on the charts used to be small in relation to the stock price, such as a two-point range on a $25 stock, these same ranges became much larger, such as a five-point range on that same stock.

Breakouts still occurred but price movements following those moves were faster and stronger to create condition where investors had to anticipate breakouts in order not to be left at the starting gate.

This increased risk as investors were obliged to violate the rules of the charts and buy before the market signaled it was time. Again, chart watchers were forced to adapt their analysis to the market's changes.

Even though chart analysis lends itself equally well to individual stocks, sector work and the market as a whole, broad market moves are now widely anticipated. With the proliferation of online trading, charting has fallen victim of its own success as investors are forced to break the rules of analysis to get the jump on others. Every one knows about the adage, "Sell in May and go away" so they begin to sell in April to get a jump on the crowd.

Because of this, it can be said that analysis of the market as a whole has changed drastically. However, there is a happy medium between the over-analyzed market and highly risky penny stocks where individual investors can comfortably make money without resorting to guesswork.

I recommend restricting technical analysis to stocks that trade at least 100,000 shares per day so that there is a liquid market for the stock. Maintain only a watch on the overall market to keep the overall trend in mind because there are too many highly paid and highly skilled professionals focusing on what the Standard & Poor's 500 is going to do. That reduces any advantage enjoyed by small investors in the past.

In the second installment next Monday, we'll look at specific tools available to individual investors and how to apply them in picking winning stocks.

Getting Technical Mailbag: Send your questions on technical analysis to us at online.editors@barrons.com. We'll cover as many as we can, but please remember that we cannot give investment advice.

Michael Kahn writes the daily "Quick Takes Pro" newsletter (you can get a free trial at www.quicktakespro.com). He is the author of two books on technical analysis, most recently *Technical Analysis: Plain and Simple*, and was Chief Technical Analyst for BridgeNews. He also is on the Board of Directors of the Market Technicians Association (www.mta.org).

Putting Stocks to the Technical Test

Michael Kahn

November 13, 2006

LAST WEEK, WE DISCUSSED what technical analysis is, and why it's a legitimate tool for determining whether a stock is worth buying or selling.
This week, we are going to lay out a set of basic yet powerful tools available to small investors for free on the Internet so they can perform their own "technical" tests on a stock they might be interested in. We will also show how this set of techniques squares with the better-known fundamental analysis practices by most analysts on Wall Street.

There will be no math, and we'll limit the jargon to the bare minimum.

While professional technical analysts have dozens, if not hundreds, of tools at their disposal, most fall into only a few categories. Individual investors need to apply only a few techniques and indicators to capture the lion's share of analytical information the pros use. And these tools are very easy to understand, too.

There are four major categories of tools in a complete technical toolbox and novice chartists need only worry about three of them. The fourth, sentiment analysis, is tricky even for the pros so let's leave that for another time.

Rather than list them by jargon-laced names, here are the three basic goals of the tools:

- **Seeing where the stock is currently trading and figuring out how it got there.** This is where we explore charting tools such as stock trends, support levels, (that point at which a stock is trading at level at which demand is thought to be strong enough to prevent the price from declining further) and resistance levels (that price at which selling is thought to be strong enough to prevent the price from rising further). It is also where all those crazy-named chart patterns live but we'll leave them, too, for another time.

- **Determining the power of a trend.** This is also where we can find signs of a pending end of a trend. For that, we will look at such important technical concepts as trading volume and momentum.
- **Making comparisons of the stock to the market, its peers in its own industry and even to its own history.** This is where we look at relative performance and moving averages.

If we know how fast a stock is moving, how much power is behind it and how it stacks up to the market, then we'll gain a huge advantage over other investors looking only at the fundamentals such as price-to-earnings ratios, return on equity, or earnings growth.

A solid company with a solid chart is hard to beat.

Let's now discuss specific tools found on free Internet charting sights such as BigCharts.com, Yahoo Finance and Stockcharts.com. By plugging in a stock symbol and setting a few conditions, all of these tools can be applied to that stock on a single chart. Further, most charting sites allow users to save these conditions so analyzing an entire portfolio requires just a set of stock symbols.

In looking at a stock, here is a checklist of key technical tools.

- **Trends and trendlines** -- There is no secret to finding a trend. If prices are generally rising and making higher highs as well as higher lows, then we have a rising trend. Most charting Web sites also offer the ability to draw trendlines on the chart to clearly define the trend more objectively. Alternatively, the old fashioned way of printing the chart and using a ruler and pencil works just as well. We want stocks that are in rising trends.
- **Support and Resistance** -- These are terms that simply tell us what price levels are likely to bring out the buyers (demand) or the sellers (supply), respectively. What we want to see is a current price that has either just moved through resistance (demand overwhelmed supply) or one that is far from the next resistance level.
- **Moving Averages** -- Moving averages, or simply price averages, are just average prices over a user-defined period of time, usually 50 or 200 days. They help us determine if a trend is turning, as prices cross the averages. They also help us determine if an existing trend is

progressing in an orderly manner or if it is accelerating in a frenzy. Clearly, we are looking for price to be above selected averages but not too far above them.

- **Volume and Momentum** -- These two indicators confirm the health of a trend or warn of an impending change. We are looking to see if buying is spreading to other investors, as evidenced by rising trading volume. We also want to know if days when prices rise outnumber and result in bigger price moves than days when prices fall (momentum). If either volume or momentum starts to fade, then we can surmise that the trend is weakening.
- **Relative Performance** -- Relative performance charts simply divide the price of a stock by a relevant market index or industry group. The theory is that we should buy strong stocks in strong sectors and this is how we find them. If the ratio is going up then the stock is outperforming the market or industry and is thus a strong candidate for further gains. If the ratio is going down, then the stock is lagging and is often more vulnerable to bad news.

Now that we have the theory and the tools, let's look at the process of going from a stock idea to an actual decision to buy or sell.

1. Look at the trend. We want a rising trend or one that is just starting to do so.

2. Find nearby support and resistance levels. We are trying to find stocks where demand exceeds supply and new supply is not likely to develop soon

3. Determine if the current trend is healthy. We want prices to be above a relevant moving average but not so far that the stock is prone to a snapback decline as profit taking sets in.

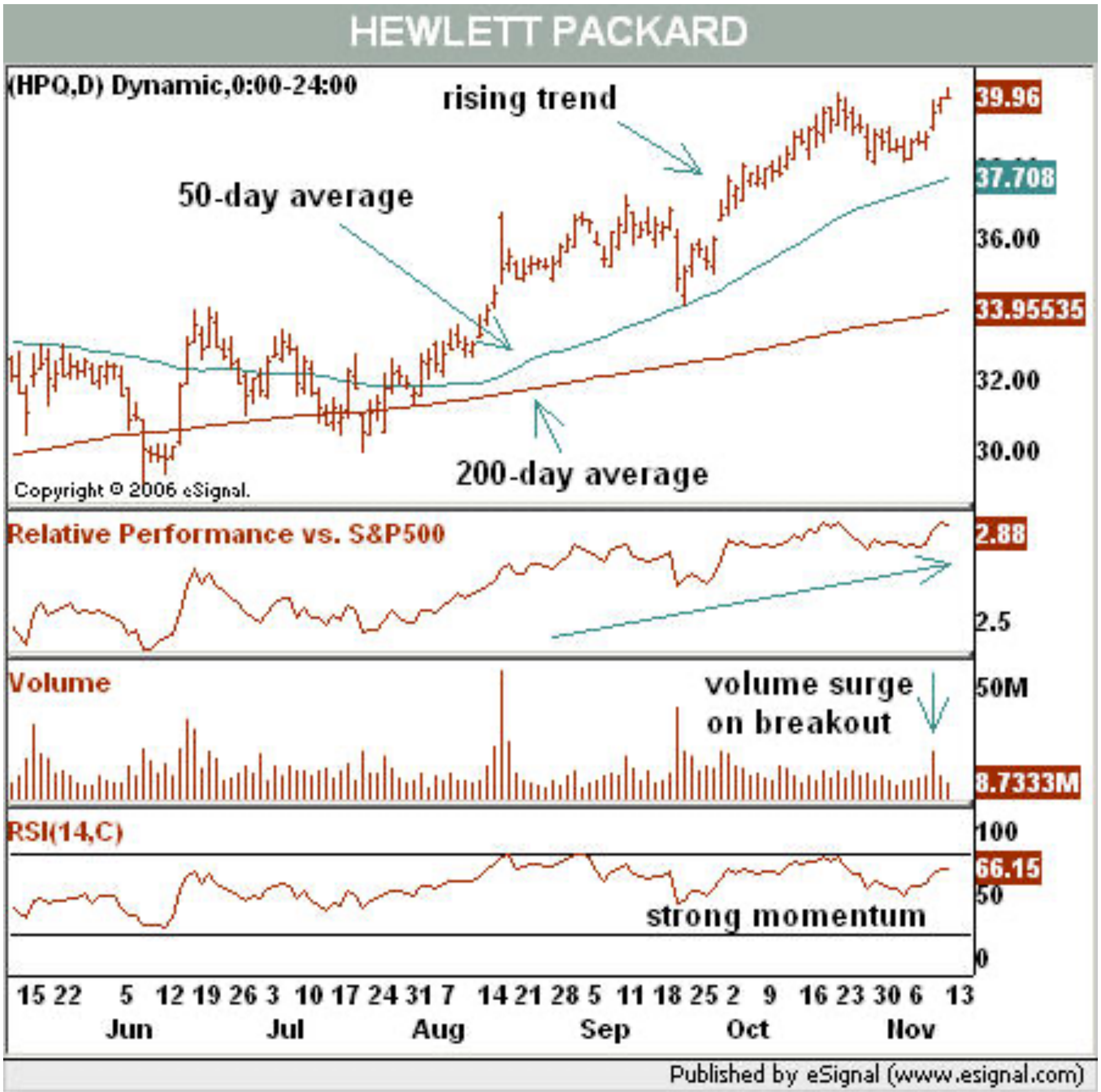
4. Check volume and momentum indicators to be sure that they are not fading as the stock price rises. A falling indicator warns that there might be technical problems before price action sours.

5. Find out if the stock is leading a benchmark. Is the particular stock at least matching the performance of the market and its peers?

6. If the stock passes all these tests, we have a candidate for purchase.

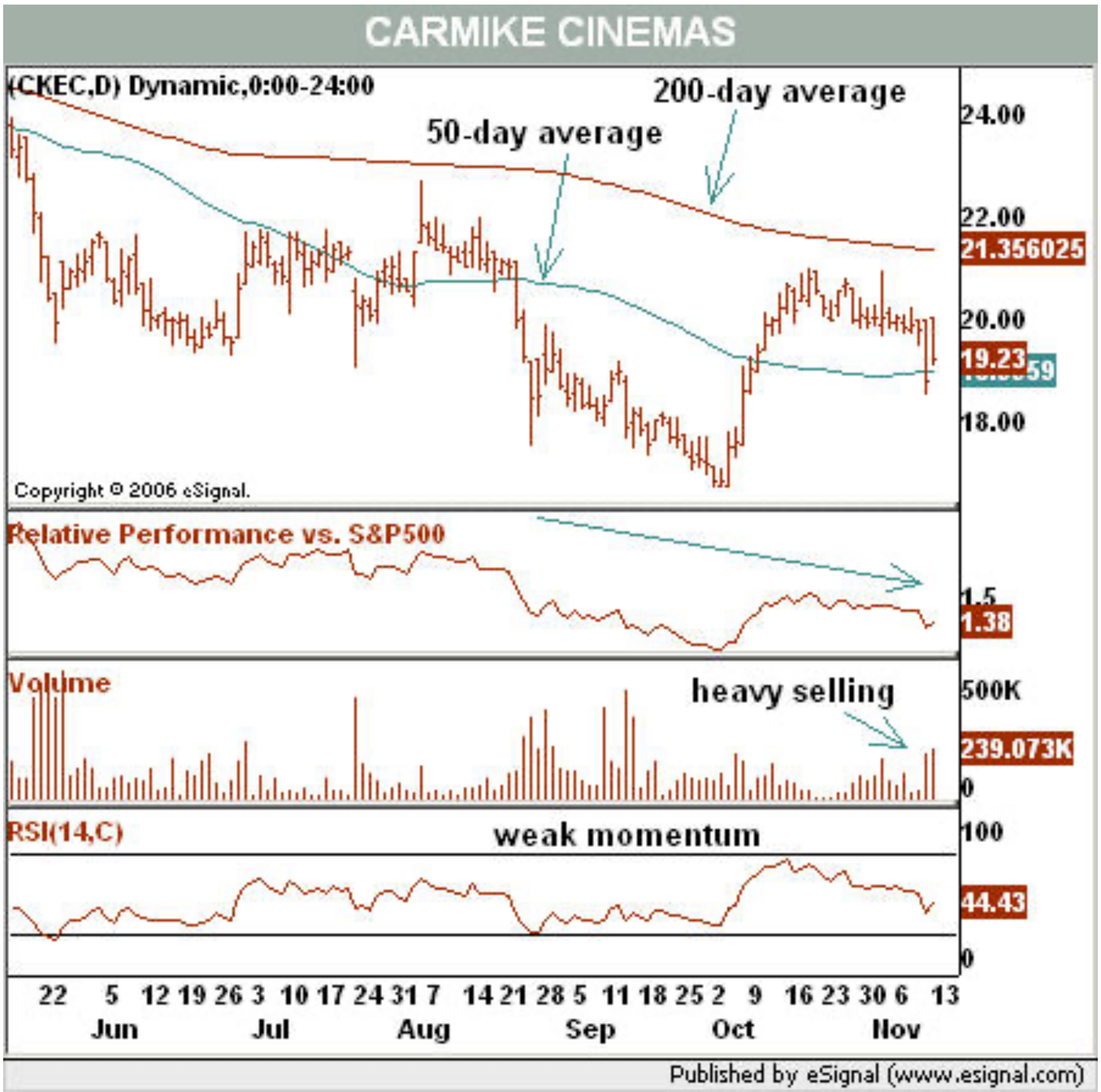
[Hewlett-Packard](#) is an example of a stock that passes these tests today (see Chart 1). It has a rising trend and when its October correction ended it had a surge in price and volume as investors piled in. Momentum readings are positive, the recent low did not violate the rising 50-day moving average and prices are above a nicely rising 200-day average. Relative strength analysis shows it outperforming the market and there is no meaningful resistance in sight.

Chart 1



An example of a stock that does not pass these tests is [Carmike Cinemas](#) (see Chart 2). While some may think that all the bad news is out and that it is now cheap, especially with today's analyst upgrade, the market has clearly said the opposite. The trend is down, as are moving averages, and the stock is badly lagging the market. A recent recovery attempt was aborted with Friday's heavy sell off and momentum indicators are at levels associated with a bearish trend that is still in progress.

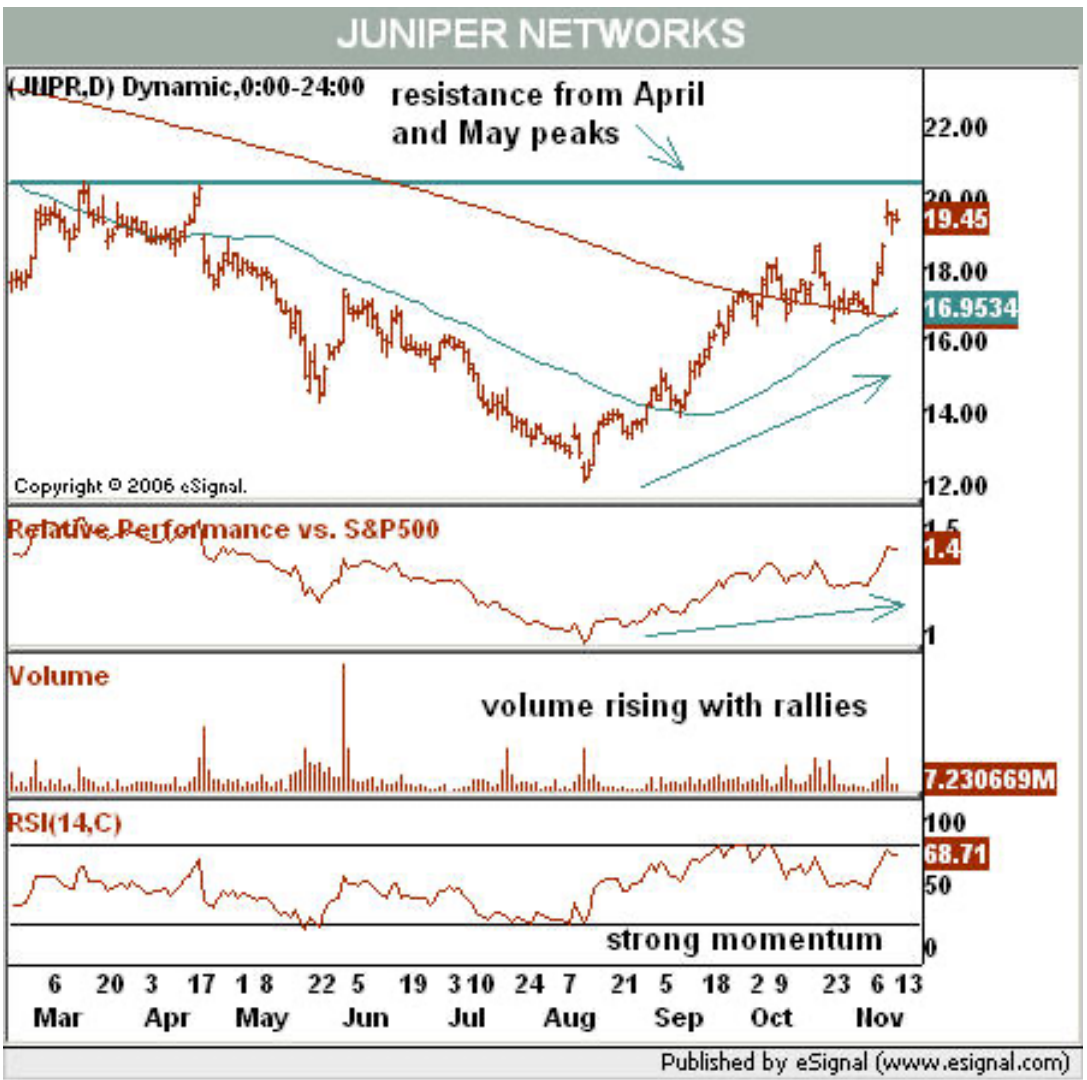
Chart 2



These are clearly cherry-picked examples of technically good and bad stocks. In the real world, it is rare to find all technical ducks in a row, and we must make judgment calls about whether enough factors are in our favor.

Juniper Networks is an example of a stock that passes most tests but not all (see Chart 3). On the positive side, it has a rising trend, recently moved above a short-term resistance with a surge in volume (demand). It also bounced off both its 50-day and 200-day moving averages last month. Finally, it has also been outperforming the market since August.

Chart 3



But there is a rather strong resistance just overhead at 20.50 from the peaks of March and April. At that time, the stock was licking its wounds following a disastrous seven-month performance that culminated in a one-day plunge. Bottom fishers were nibbling and investors who bought just prior to the plunge were looking at their chance to break even by selling near the pre-breakdown price. In other words, a good deal of supply was waiting to come into the market and that very same condition exists today.

The strategy is to put this stock on the radar screen and watch how it reacts as it hits 20.50. If it powers through that level then we know the market has absorbed all that supply. Waiting to buy may give up a point or so of potential profit but it reduces the risk of loss should the market be unable to soak up that supply.

At this point, we must address how fundamental analysis -- which looks closely at a company's management, products, and competitive landscape in an effort to determine its future earnings and intrinsic worth -- and technical analysis can have different conclusions about the same stock. For example, a stock that has strong technicals may be overvalued based on the fundamentals. Conversely, a stock may seem cheap based on the fundamentals while technicians are selling it because it failed to meet many of the tests cited above.

This is not a problem with either method as there will be times when the market sees things the fundamental analyst does not see.

There will also be times the fundamental analyst knows something about the company that is being overwhelmed by some non-company specific news. An example might be a positive earnings forecast on a day when a peer stock releases bad news that sends the entire sector lower.

When both fundamentals and technicals line up, investors can buy with confidence. But even when they don't line up, simply being aware of risks from either side empowers investors to make better decisions.