# Why Technical Analysis Matters

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Technical analysis is a bit of a misnomer since it is really not that technical. A better name for the use of charts to make investment decisions might be risk/reward analysis or even market psychology.

Sure, there are some complex mathematical concepts involved with some of its more esoteric indicators. But at its core, technical analysis is simply a method of determining if a stock or the market as a whole is worth buying or selling. Once we identify this we are way ahead of the game with regard to assembling a winning portfolio.

## What Is Technical Analysis?

Simply stated, technical analysis is the study of data generated from the market and from the actions of people in the market.

Such data includes price levels that have served as turning points in the past, the amounts of stock being bought and sold each day (volume), and the rate of change of price movements (momentum) over a given span of time.

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. Was investor sentiment ever as negative as it was in March 2009 when the market put in a very important bottom?

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 status of 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. There is no such thing as a revision to last quarter's government report.

This is not a knock on fundamental analysis, which was made famous by men like Graham and 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.

Figure 1. Triangle Pattern and Breakout

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 Figure 1). 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. 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 do not hang around hoping the stock will go back up. Hope is a four-letter word in the world of investing.

If you are interested in charting individual stocks, I recommend restricting analysis to stocks that trade at least 100,000 shares per day so that there is a liquid market. Maintain only a watch on the broader 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.

**Step-by-Step: The Theory**

Basic chart analysis is really rather easy. Let's lay out a set of basic yet powerful tools so you can perform your own "technical" tests on a stock in which you might be interested. I 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 I will 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 not only very easy to understand, they can be found for free on the Internet.

There are four major categories of tools in a complete technical toolbox, and novice chartists need only be concerned with three of them. The fourth, sentiment analysis—where we try to figure out if fear or greed is in control of the marketplace—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 a level where 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 I will not focus on them in this article.

*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 will gain a huge advantage over other investors looking only at the fundamentals such as price-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 many Internet charting sites. [Editor's Note: See the CI in the Journal column for a description of two of the best charting sites.] 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.

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**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—or private bull markets, if you will.

### 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 days or 200 days. They help us determine if a trend is turning as prices move above or below 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 the days when prices rise outnumber—and result in bigger price moves—the days when prices fall (momentum). If either volume or momentum starts to fade, then we can surmise that the trend is weakening.

Think of a car running out of gas. It will continue to move forward but its pace slows and well before it stops we know something is wrong.

### 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 a strong candidate for further gains. If the ratio is going down, the stock is lagging and is often more vulnerable to bad news.

### Step-by-Step: The Process

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 rise.
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 above 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?

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

Figure 2. Stock in a Rising Trend

Hewlett-Packard (HPQ) is an example of a stock that passed these tests in November 2006 (see Figure 2). It had a rising trend and when its October correction ended, it had a surge in price and volume as investors piled in. Momentum readings were positive, the recent low did not violate the rising 50-day moving average and prices were nicely above a rising 200-day average. Relative strength analysis showed the stock outperforming the market and there was no meaningful resistance in sight.

Figure 3 shows an example of a stock that did not pass these tests, Carmike Cinemas (CKEC). While some thought that all the bad news was out and that the stock was a bargain, especially with the fundamental analyst upgrade on the day this chart was created (November 13, 2006), the market clearly said the opposite. The trend was down, as were moving averages, and the stock was badly lagging the market. A recent recovery attempt was aborted with the heavy sell-off on November 10 and momentum indicators were at levels associated with a bearish trend that was still in progress.

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.

Figure 3. Stock in a Down Trend

Juniper Networks (JNPR) is an example of a stock that passed most tests but not all in November 2006 (see Figure 4). On the positive side, it had a rising trend and 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. Finally, it had also been outperforming the market since August 2006.

But there was 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 existed at the time this chart was printed.

Figure 4. Stock With Mixed Indicators

The strategy was to put this stock on the radar screen and watch how it reacted as it hit $20.50. If JNPR had powered through that level, then we would have known the market had absorbed all that supply. Waiting to buy may have given up a point or so of potential profit, but it would have reduced the risk of loss should the market have been unable to soak up that supply.

## Fundamental Versus Technical Analysis

At this point, I must address how fundamental analysis 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.

There 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 do not line up, simply being aware of risks from either side empowers investors to make better decisions.