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Understanding Support and Resistance Levels

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As an investor taking a position in a security, it can be important to take a quick look at its chart to determine what may lie above or below the current price level based on the picture you see. A sharp eye can pick up areas on the chart where trend lines can be and become useful in determining areas of support and resistance. An area of support is found below the current price and is a level at which the price may hold and not go any lower under the right conditions.

Points higher than the current price that could prove difficult to rise above are known as resistance levels. There are many reasons in the technical analysis profession that could cause areas of support and resistance on a chart. Finding these levels along with other specific analysis is often a way to provide additional reasons for a purchase or sale of a security. (For more, see: *To Sell Or Not to Sell*.)

Why This Matters?

The levels of support and resistance can offer an investor a secondary indicator while selecting between various investments. In comparison to other potential securities, an investment that has a good resistance level as well as multiple levels of support below the current price may be a better choice than one without support or too much resistance near the current price. Violation of levels is also a way to determine if an investment may be likely to keep going in the same direction of the violation until the next level that may be reached. Having multiple levels showing on a chart will provide the buyer or seller of a security valuable information that can aid in the decision to buy or sell at current levels.

An example from Technical Analysis

This example shows a market that is in a consolidation period over the course of a few months. During that time, a number of levels that could be considered support and resistance have developed. The red resistance level overhead is converging with the green support level from below. There are a number of black horizontal Fibonacci levels that have been established off of the high and the low of this consolidating range. A blue 200 day simple moving average line is rising and can be considered an important level of support should this range be broken to the downside.

How to View It

In the field of physics, Newton's First Law tells us an object in motion will stay in motion until acted upon by another force. This can be related to the actual support and resistance levels we see on the chart. It is often the case that we see prices move towards these levels despite any fundamental reasons, and they will continue to move toward those levels before reversing course. Thus, doing a thorough chart study of each investment that is chosen to buy or sell and using these levels based on many specific technical indicators may help.

For example, when there is a price range (a consolidation pattern as shown below), we look at Fibonacci levels (based on mathematics) as well as areas of trend line support and resistance. There may also be areas of minimal price consolidation appearing that can provide future price movement to stay within that same range. In all cases, we are trying to design our risk-to-return ratio of any investment we choose to purchase by keeping the downside risk in mind and finding the support levels below our price to minimize a potential loss on the investment we are making. Though not a guarantee, we find this is a helpful method to assist in managing assets and feel you can benefit in the same by taking this approach too. (For more from this author, see: *Selling a Stock: When Is the Right Time?*)

Important Disclosures:

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