

TECHNICAL ANALYSIS

The Visual Clue

WHAT IS TECHNICAL ANALYSIS

IN HIS BOOK *TECHNICAL ANALYSIS EXPLAINED*, MARTIN J. PRING EXPLAINS:

“THE TECHNICAL APPROACH TO INVESTING IS ESSENTIALLY A REFLECTION OF THE IDEA THAT PRICES MOVE IN TRENDS WHICH ARE DETERMINED BY THE CHANGING ATTITUDES OF INVESTORS TOWARD A VARIETY OF ECONOMIC, MONETARY, POLITICAL AND PSYCHOLOGICAL FORCES. THE ART OF TECHNICAL ANALYSIS - FOR IT IS AN ART - IS TO IDENTIFY TREND CHANGES AT AN EARLY STAGE AND TO MAINTAIN AN INVESTMENT POSTURE UNTIL THE WEIGHT OF THE EVIDENCE INDICATES THAT THE TREND HAS BEEN REVERSED.”

BASIC PREMISES OF TECHNICAL ANALYSIS

- **Barring minor deviations, stock prices tend to move in fairly persistent trends.**
- **Shifts in demand and supply bring about changes in trends.**
- **Irrespective of why they occur, shifts in demand and supply can be detected in charts.**

TECHNICAL ANALYSIS VERSUS FUNDAMENTAL ANALYSIS

Technical Analysis

- Predicts short-term price movements
- Focuses on internal market data
- Appeals to short-term traders

Fundamental Analysis

- Establishes long-term values
- Focuses on fundamental factors
- Appeals to long-term investors

CHARTING TECHNIQUES

- **THE DOW THEORY**
- **BAR AND LINE CHARTS**
- **POINT AND FIGURE CHART**
- **MOVING AVERAGE ANALYSIS**
- **RELATIVE STRENGTH ANALYSIS**

BASIC CONCEPTS UNDERLYING CHART ANALYSIS

- Prices move in persistent trends
- Volume and trend go hand in hand
- There are resistance and support levels

THE DOW THEORY

The market has three movements, all going at the same time:

- **Daily fluctuations** : Random day-to-day wiggles
- **Secondary movements** : Corrections that last for a few weeks or months
- **Primary trends** : Representing bull and bear phases of the market

BAR AND LINE CHARTS

- **The bar chart depicts the daily price change along with the closing price.**
- **A line chart shows the line connecting successive closing prices.**
- **Technical analysts believe that certain formations or patterns observed on the bar chart or line chart have predictive value. For example, a head and shoulder pattern represents a bearish development.**

POINT AND FIGURE CHART

More complex than a bar chart, a point and figure chart (PFC) condenses the recording of price changes by eliminating the time scale and small changes.

RELATIVE STRENGTH ANALYSIS

The relative strength analysis is based on the assumption that prices of some securities rise rapidly during the bull phase but fall slowly during the bear phase in relation to the market as a whole.

THE ADVANCE-DECLINE LINE

The advance-decline line is also referred to as the breadth of the market. Its measurement involves two steps:

1. Calculate the number of net advances/declines on a daily basis.
2. Obtain the breadth of the market by cumulating daily net advances/declines.

NEW HIGHS AND LOWS

Technical analysts consider the market as bullish when a significant number of stocks hit the 52-week high each day.

On the other hand, if market indices rise but few stocks hit new highs, technical analysts view this as a sign of trouble.

VOLUME

Volume analysis is an important part of technical analysis.

Other things being equal, a high trading volume is considered a bullish sign. If heavy volumes are accompanied by rising prices, it is considered even more bullish.

SHORT-INTEREST RATIO

The short interest ratio is defined as follows:

Total number of shares sold short

Average daily trading volume

A technical analyst considers a high short-interest ratio as a sign of bullishness

MUTUAL FUND LIQUIDITY

Low mutual fund liquidity is considered a bearish factor

High mutual fund liquidity is considered as a bullish indication

PUT/CALL RATIO

Number of puts purchased

Number of calls purchased

A rise in the put/call ratio is a buy signal

A fall in the put/call ratio is a sell signal

TRIN STATISTIC

Volume declining / Number declining

Trin =

Volume advancing / Number advancing

Thus trin measures the ratio of average volume in declining issues to average volume in advancing issues. Generally, a trin ratio of more than 1 is deemed bearish as it means that the declining stocks have higher average volume compared to advancing stocks, suggesting a net selling pressure.

TESTING TECHNICAL TRADING RULES

- DOES THE TRADING RULE PRODUCE EXCESS RETURN AFTER ADJUSTING FOR RISK?
- DOES THE TRADING RULE PRODUCE EXCESS RETURNS AFTER ADJUSTING FOR TRANSACTION AND OTHER COSTS (LIKE TAXES)?
- HOW CONSISTENT IS THE PERFORMANCE OF THE TRADING RULE?
- IS THE TRADING RULE VALID OUTSIDE THE SAMPLE?