AN *e*-BURST OF INSPIRATION FROM THE BEST BOOKS

Michael N. Kahn, CMT

IS TECHNICAL ANALYSIS FOR INVESTORS REALLY ALL TECHNICAL?

FT Press Delivers *elements*

FINANCIAL TIMES

Is Technical Analysis for Investors Really All Technical?

Michael N. Kahn, CMT

What a terrible name has been bestowed upon this method of market analysis—technical. It is about as technical as singing. Designing electronic circuit boards is technical. Developing a new bio-medical implant device is technical. Market analysis? That is not technical.

True, there are technical terms and complicated research. Mathematical modeling can also play a role, but strip away all the advanced-level components, and technical analysis is just a tool investors and traders use when deciding to buy or sell a stock, bond, currency, or commodity.

One analogy that can be used is that of the carpenter. Market technicians carry with them a technical toolbox filled with the studies, patterns, and classifications. The carpenter uses a hammer to drive a nail, not a screwdriver. The technical analyst might use a momentum indicator to assess the health of the market, not linear regression. Both tools are good, but each has its own special use.

Technical analysts do not even expect to be correct in their decisions all the time. With the proper money management and mastery of one's ego, a 60 percent success rate will put one at the head of the class. A little higher success rate would be expected from a surgeon or an airport control tower. Perfection is technical. Market analysis is not.

So how is technical analysis like singing? For starters, everyone can do it. Most people may not be good at it and therefore will not be doing concerts for the Queen. Others, with training, practice, and desire, will master the basics to make their portfolios sing.

Sure, singing can be broken down into physiological components of breathing, posture, and throat control. Psychologists may cite right-brain dominance and perhaps innate musical ability. Most singers, save for those at the top professional levels, do not study these components. Rather, they know the basics of singing and apply it for fun. This is the feeling you should get as you learn a few lessons in market analysis. You do not need to know every study and every technique top technical traders use, because you are not trying to become a top technical trader at this point in your investing career. You will have your "fun" when you see your results improve. Maybe you will get hooked on charts and decide to pursue technical analysis as your primary discipline. Maybe not. You are not going to change from a karaoke singer to Frank Sinatra overnight.

Technical analysis has been saddled with a poorly descriptive name. Technical analysis is not technical like electronics, but more diagnostic like the role of a doctor.

Components

Technical analysis is the art of identifying market turning points at a relatively early stage. The goal for all but the most aggressive of traders is to ride the bulk of the trend as far as possible without attempting to pick the exact tops and bottoms.

The Chart

The basic component of technical analysis is the chart. Depending on how detailed the analysis is going to be, the chart captures all relevant data and displays it in a logical format. Of all the information that can

emerge from it, the most important is how the market got to where it is at any given point in time. How it moved from price A to price B over time reveals a great deal about supply and demand, investor sentiment, and pent-up price potential.

Consider a market that has moved in a very small price range for months. Trading activity has been relatively low, and very little news has emerged. In short, the market is boring. Few people are interested in following it at all. One day, trading volume suddenly doubles. Given that low normal volume, this doubling is still mostly unnoticed by the public, but the people who bought that day knew something was going on. Perhaps they only thought they knew something, but the result is the same: a doubling of volume.

For whatever reason, demand rises. The market breaks out of its price range, something technicians call a base or basing pattern, and begins to rise. Often, the good news that caused this breakout is released to the public and the rally begins in earnest.

Is this inside information? No, it is not. Remember that information flow is not perfect. Somebody either knew it early or took a gamble that it was true. If information flowed to everyone at the same time, then there would be no such thing as a bull or bear market. Prices would jump from one equilibrium level to the next in an instant. Technical analysis attempts to determine where the market is in the process of information dissemination to determine if it is in the early, middle, or late stages of a trend.

The Supporting Cast

To the basic chart can be added indicators that can quantify market momentum (how fast the market is moving), trade volume (how much power is behind the moves), and even the natural order of crowd behavior (sentiment).

A complete technical analysis of a stock, for example, could also include technical treatment of fundamental data such as earnings and dividends. To say that company XYZ has raised its dividend for 20 quarters in a row is to say that the trend in dividends is rising at a steady rate. A plot of earnings that shows an increasing slope suggests that stock prices will soon follow.

What Is the Market?

Just as is learned in Introduction to Economics courses, the market for stocks, bonds, commodities, or foreign exchange is comprised of buyers and sellers. The price at which they trade is determined by supply and demand.

The following list breaks down the process further. As can be seen, the prime mover of markets is the perceptions of the people in it.

- The market is comprised of buyers and sellers.
- Price is determined by supply and demand.
- Supply and demand are determined by the aggressiveness of the bulls and the bears.
- Bullish and bearish actions arise from perceptions of value.

Notice that actual value is not in the list. What a market should be worth based on mathematical and economic models is not the deciding factor in the prices in the morning newspaper tables. Technical analysis is positioned to follow the discrepancies between forecast and perceived value.

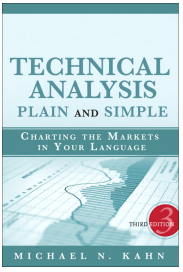
The Herd

The psychology of crowds, also known as the herd mentality, is an important part of technical analysis. Why the herd? Investors and traders are also human beings. Humans prefer to be accepted, and like their animal counterparts, they will follow the herd for psychological safety.

Continuing with the animal analogy, imagine that a herd of zebras in Africa perceives a threat from a nearby pride of lions. The herd begins to run. All zebras within it stay together to present a blur of white and black stripes to the lions. This is a trend. As long as the herd moves, all individual zebras will move with it and consider themselves safe. Consider this the zoological equivalent of the "trend is your friend," one of the more common adages in the investment world.

Now imagine that the herd becomes so preoccupied with the simple act of running that it forgets to look ahead at the changing landscape. Up ahead is a deep ravine. Here, at the end, the trend is no longer your friend, so to avoid certain death, the individual zebra should be looking for a way to break from the herd. This is a lonely proposition for both zebra and investor—going against the crowd to stand alone. The zebra must consider if the lion is still out there. The investor must weigh the psychological discomfort of standing alone against the financial discomfort of following the crowd past the end of the rally.

So what is the market? It is the conglomeration of the actions and perceptions of all participants. It develops its own consciousness, not unlike that of millions of nerve cells coming alive together in a brain. Like a living organism, no single cell is more important than the whole, so we, as individual cells, must remember our place. The market can never be wrong.



If you liked this Element, you might like the book by Michael N. Kahn, *Technical Analysis Plain and Simple: Charting the Markets in Your Language, Third Edition* (ISBN: 978-0-13-704201-2).

FT Press
FINANCIAL TIMES
Delivers

Vice President, Publisher: Tim Moore
Associate Publisher and Director of Marketing: Amy Neidlinger

Publishing as FTPress Delivers
Upper Saddle River, New Jersey 07458

ISBN-10: 0-13-707101-9
ISBN-13: 978-0-13-707101-2

For more information, please contact us at info@ftpress.com