The Professional Ticker Reader TM

Your **a**ccurate, **a**uthentic and **a**ffordable guide to investing

Technical analysis explained - I

Why technicals ?

The markets have been rallying in the last few months and many a trader / investor is wondering if there is a method in the madness in the process of investing. Technical analysis shows a way out to the serious player who is interested in optimising his returns on investments. I would advocate every player who has some interest in stocks should have a working knowledge of technical analysis. Going by the maxim of " knowledge is power " , technical studies provide handy tools akin to the versatile swiss army knife to all players.

What is technical analysis ?

Technical analysis is all about studying stock price graphs and a few momentum oscillators derived thereof. It must be understood that technical studies are based entirely on prices and do not include balance sheets, P&L accounts (fundamental analysis), the assumption being that the markets are efficient and all possible price sensitive information is built into the price graph of a security / index. Therefore, technical analysis supports the efficient market theory as against the "random walk theory" which supports the belief that stocks can be bought / sold on random events like flipping a coin !!! I believe that technical analysis is more dynamic as compared to fundamental analysis based on one simple argument - fundamental analysts depend on corporate events like quarterly results and special announcements like earnings guidance and policy changes in operations to generate a buy / sell recommendation. If fundamental analysis was the single most reliable indicator of trends, prices would predominantly fluctuate only 4 - 5 times a year - around quarterly results and special announcements like mergers and acquisitions etc !! Why would prices fluctuate almost daily ? If the prices fluctuate ever so often, is there a way to forecast them ? yes according to technical analysis !!

Schools of thought

Technical analysis has evolved over a period of centuries and every geographical region has contributed it's flavour to the study. The west has given us the venerable Dow theory which was advocated in the early 1900's and the Elliot wave theory advocated by R.N. Elliot. While the dow theory (using typical bar charts and oscillators as we know them) remains the most basic and widely practiced due to it's simplicity, elliot theory uses intraday charts and bases it's computation on the principle that prices move in waves and that upmoves come in 5 waves and downmoves in 3 waves.

Oriental theories are as old as the hills as the japanese candlestick theories formulated by the rice traders in Sakata province of japan. They use bullish and bearish candles to determine the trends in the markets. This theory uses life-like terminology like the morning star, hanging man, evening stars etc to denote chart patterns. The chinese have the yin and yang theory which is similar to the Japanese candle-stick patterns. I would advocate using the Dow theory based on the sheer simplicity of the same.

Tools of the trade / tricks of the trade

Technical analysis requires an eficient charting system. While it is almost mandatory to have a computer and a software that will generate charts based on periodic data updates available, some basic studies can be carried out with a simple graph paper being used as a charting board with a X & Y axis. Most newspapers provide price updates with volumes which should be sufficient to plot basic price graphs. If you have a PC and a software you are already a few steps ahead.

The nuts and bolts

In a complex looking charting screen, it must be remembered that the price graph is the meat and the oscillators are the ketchup. The mistake most novice technical analsysts make is to give an excessive emphasis to oscillators. Please remember thet oscillators are derived from price graphs and not vice-a-versa !! Some basic observation will tell us that some charts are more appealing than the others. some thumb rules to pick the winners from the losers -

- If a stock is making a rising bottom and top formation (higher highs and lows), the stock is displaying strength. Especially true if the prices are making new highs and that too with high volumes. Volumes play a very large role in the projections as they signal participation or lack of it. If traded volumes are poor, it shows cynicism on the part of investors / traders in the prospects.
- As long as the prices are rising, stick to the counter and let your profits run, remember the trend is your friend till it reverses and ends.
- Technical analysis advocates a very dynamic system of financial / risk management. As a thumb rule, when you buy a share, a stop loss on the day of entry (on the long side) should be the previous days lows. As

the prices rise progressively, it is important that the stop losses be modified too - this entails initiating "trailing stop losses". Suppose you buy a security ABC Ltd at 100 and maintain a stop loss at 92. A week after you purchased it, the price escalates to 120, you cannot maintain the same stop loss !! A trailing stop loss should raise the protective stop by atleast 18 % (since the price appreciated 20 %) so that even if the prices reverse abruptly, even your notional gains are protected. In my opinion, the smartest market players are not those who make lots of money on stray trades, but those who make money consistently. Therefore, risk management is as important as profiteering.

- Moving averages are one of the most reliable indicators of trends in formation. Since the moving average is computed by taking an average price over a pre-determined number of days, it smoothens out the erratic movements of the stock on a day-to-day basis. Many successful traders use moving averages to build a highly successful trading system to profit from bull and bear markets. Rule of the thumb system that any investor / trader can implement is the 10 day moving average. If the said moving average is rising, and the stock price is ruling above this MA, stay long on the counter. Sell only when the price violates the MA in a downward direction.
- Some of the most useful oscillators are those that measure the strength of a share - RSC (relative strength comparative) and beta measure (volatility). These indicators cater to different types of market players. RSC measures the strength of an individual counter vis-a-vis the benchmarks (typically sectoral / market indices). The higher the RSC reading, the more likely the share is of appreciating in good times and bad. It has been observed in a study spanning over 30 years that investors who invest in high RSC stocks at any point of time are invariably in profit over a reasonable period of time. If these stocks are bought during bear markets, the results are superlative. Beta measure oscillator on the other hand measures the short term volatility of a share. This oscillator is every short term traders delight. A high beta reading shows higher swings in the price as compared to the broader markets - both in bulls and bear phases. It must be noted that a high beta reading does not necessarily mean a high RSC reading.

In addition to the above, there are many practical patterns that would help a market participant identify opportunities and exploit the same to forecast the price movements. The same will be covered in the concluding part of this article.

Vijay Bhambwani

Ceo - BSPLindia.com

The author is a Mumbai based investment consultant and invites feedback at vijay@BSPLindia.com or (022) 23438482 / 23400345