

Tech School

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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. In this first piece in the series of three articles, we take a step-by-step approach to understanding this subject.

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 !!

<ul style="list-style-type: none">• Is a medley of Science & art. No algebraic / empirical formulae.• Involves study of price charts and oscillators derived thereon.• Study regards price as the ultimate factor, which factors in fundamental factors as well. Does not subscribe to the random walk theory.• Signals generated by market action on prices.• Chances of multiple interpretations are higher.• Will generate more signals, works for catching MOST price movements.• Will generally generate signals in advance.• Involves built-in capital / risk management techniques.	<ul style="list-style-type: none">• Is a pure science form, involves pre-set parameters for investment decision support systems.• Involves study of Balance Sheets, P & L accounts.• Study regards price movements as a random phenomena, caused by market forces.• Signals generated by corporate actions.• Chances of multiple interpretations are lower.• Will generate fewer signals, works better for catching major moves.• Will generally generate delayed signals.• Involves NO risk / capital management techniques.
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Schools of thought

Technical analysis has evolved over a period of centuries and every geographical region has contributed its 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 its simplicity, Elliot theory uses intraday charts and bases its 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 efficient 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 analysts make is to give an excessive emphasis to oscillators. Please remember that oscillators are derived from price graphs and not vice-a-versa !! Another aspect that I would stress emphatically is the fact that an objective approach is needed to succeed using technicals. Try to see what the chart is telling you rather than what you want to see in the chart.

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