Introduction to Technical Analysis

- by Dolnaphat Yenchaisith

Technical analysis is the analytical method which uses mathematics, statistics, and probability theory to evaluate the relevant information and convert it to results. The good technical analysts not only have to be smart observers but also have to understand human psychology (how people think). They also have to remember the price movements at each given situation because "history can and does repeat itself". This is where we consider the "pattern". So, if you can control the feeling between "greed and fear" you can survive in this game.

Although challenging, Technical Analysis is not as hard as you might think. Because we have tools to formulate the changes from the Price at Open, Close, High, Low, Change, and Volume from each period to give us tools as "indicators". The Indicator can help you understand the "Supply and Demand" and also whether a stock or index is "Overbought or Oversold". This information can be used as an indicator to predict what will happen in the near future. When a stock has no "Demand" the price will always go down because everybody would want to sell. The indicator may show a time of being "Oversold". That means no person would want to sell anymore. Then this is the time to buy. Technical Analysis can help you in the timing of when to buy and when to sell to make profit or to cut your loss. It can even help you to predict when it's time to walk away from the market entirely.

What's type of investor can do technical analysis?

Many investors may confuse themselves as to which type of investment discipline is best for them to succeed in the Stock Market. Some investors believe in fundamental analysis and some believe in technical analysis. Both types have their pros and cons. For example, in fundamental analysis they believe in "intrinsic value" or the present value of a firm's expected future net cash flows discounted by the required rate of return. But fundamental analysis fails to tell us when is the appropriate time to enter or exit the market. On the other hand technical analysis focuses on supply and demand of a stock or index at a given time to help predict the buying and selling signals to achieve maximum gain. It fails to analyze the underlying company's fiscal health.

We can see that both methods have their own advantages. The investor should know what type of discipline suits them. It should be based on their knowledge, experience, capability, capital size, liquidity needs, and holding period for investment. To understand more about asset allocation and style of investment, we can illustrate different types of investments in three different products:

1) A Fashion product: they will have characteristics of high liquidity and wide price fluctuations. The price depends largely on supply and demand in the short term. These products may become obsolete over time. Such products include clothing, computers, communication equipment, etc.

2) A Utility product: this is a product we use in normal daily life, sometimes called a consumer product. It has low margins and is purchased and sold in large quantities by wholesalers. The thing that we are concerned with here is liquidity. An example of this product is soap.

3) A Unique product: this product has value for the person who understands the product well. Sometime, they will have no liquidity at all but investors are willing to hold it for its collectible value. The price is also dependent on the opinions of the buyer and seller. Examples include antiques, stamps, and artwork.

From the type of product above we can compare what type of investor we are:

1) Fashion product: this investor must predict the needs of the market and be attuned to market situations; they should be a risk taker; making fast decisions because the market changes very quickly. As prices fluctuate, the investor can be a speculator and there is profit to be made.

2) Utility product: this type of investor may not spend as much time tracking the market as frequently as the fashion type. They focus on the liquidity of the stock so he focuses on the volume of the stock traded. We can conclude that this investor is more conservative than the Fashion product investor.

3) Unique product: this investor will concentrate on the real value of the product and the can hold it for a long period of time. They may collect more and more of this product. They will sell if they can get their desired price. We call this type of investor a "value investor".

From these comparisons the investor should have some concept in their minds as to what type of investor they are so they can manage their portfolios effectively.

What are the differences between fundamental and technical analysis?

The differences are as follows:

Fundamental analysis seeks the “intrinsic value” of a stock.

- If the intrinsic value is higher than the market value, it is “Cheap”
- If the intrinsic value is lower than the market value it is “Expensive”

Technical analysis seeks the “supply and demand” levels of a stock

- they concentrate on investor patterns.
- they believe in Investor “Sentiment” ,”Psychology” and “Market situations”

Fundamental	Technical
“Intrinsic value”	“Supply and Demand”
Growth rate (earnings, sales)	Stock situation
Balance sheet	Market situation
Industry Performance	Direction of industrial index
Profit margin	People psychology

Fundamental Investor Behavior:

- Long term holding period
- Collecting
- Risk management

Technical Investor Behavior:

- Both short term and long term holding periods
- Buying and selling decisions follow the technical signs
- Risk taker by nature

Why do people learn Technical charting?

Investors believe in technical charting because:

- they believe in supply and demand rule
- they believe that buyer buy from their emotion, not from reason
- they believe that everything moves in cycles including the stock market
- they believe insider trade occur in the market
- they believe that they should increase their reasons for making buy/sell decisions
- they believe that they can not evaluate the price of a stock from P/E or P/B ratio because nobody can say which one is cheaper or more expensive in each market situation. There are too many other criteria to take into account.

We can assume that for the same stock but in different periods of time we may have different values because different demands can push the price to change. So if we can use only stable value of P/E and P/B to define the buying or selling price then the change in interest rates, exchange rates, inflation rates or crude oil prices will not have an impact.

People buy stock based on emotion and an underlying belief to buy. They expect to buy good stock and cheap stock. But nobody can tell if a stock is truly cheap. So, the technical analyst can help to predict the emotion of people who buy and sell stock and it does so by showing a Trend.

Technical analysis will help us to find trends of the price of a stock because

- Stock’s price will reflect all information about it
- Stock’s price will move with a Trend.
- Stock prices will follow a historical pattern.

The benefits of Technical Analysis

- No need to read or listen to the news because the graph will reflect all information
- Can make the buy/sell decision solely from the graph
- Flexibility in terms of data to be used depending on the type of stock
- Save time in analysis so you can study a greater number of stocks
- Can find the price change discrepancy before fundamental analysis can do so
- Can choose to go short or long on a particular investment

Technical Analysis for the Beginner

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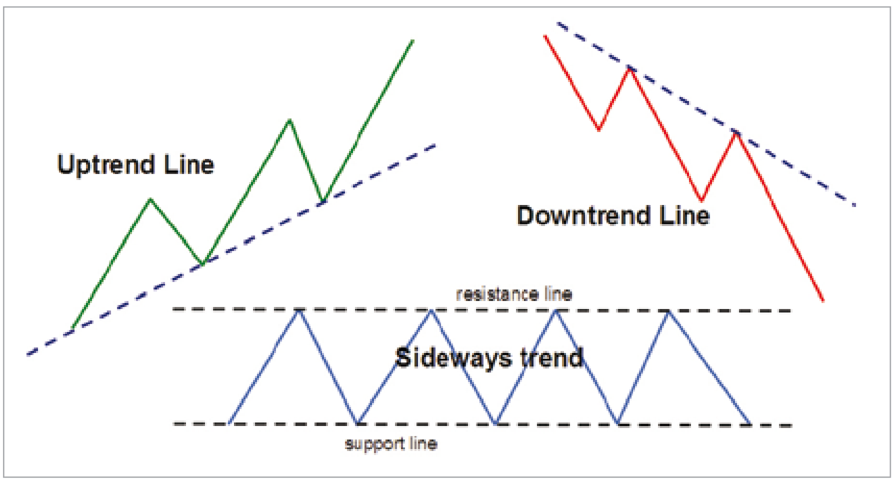
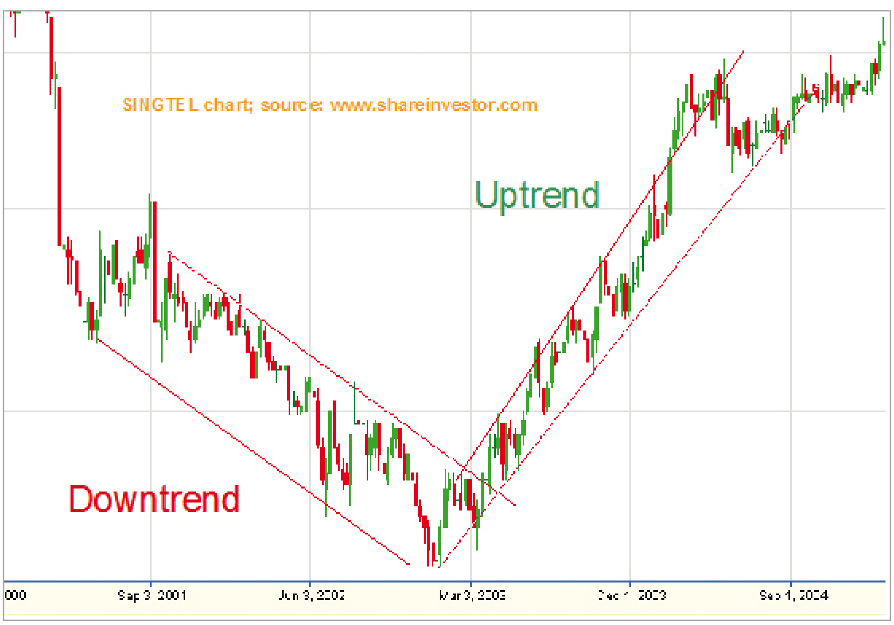
What is the Trend? Up, Down, or Sideways!

Trend Line

A Trend line is the direction of a stock price that can tell us about the future price movements. A Trend line can show "Support and Resistance levels" for investors to consider in trying determining the appropriate time to buy or sell a stock. Investors can use Trend lines with Bar charts, Candle charts, or Point & Figure charts. Also, Trend lines can be used with other indicators such as RSI, MACD, and STOCASTICS to name a few.





We can classify trends into 3 categories which are

1) Uptrend: this trend will have obvious characteristics. Each time the price rises it becomes either a new high or higher than last resistance level. As the price rises, it breaks previous resistance levels and forms new support levels. The uptrend line will be the straight line that passes through the minimum value of at least two points in the vertical upward trend, which should not have any point lower than the uptrend line. If the value of the stock is lower than this point we can assume that there direction will change.

2) Downtrend: this trend will slope downward to the right along the chart. It will mark the upper price resistance levels. The Downtrend line is a straight line from the top of the previous price resistance levels to the current price, which slopes downward. The stock's value should not have any point higher than this line. If so, we can assume that the trend will change upward

3) Sideways trend: there is upswing and downswing between the channels which show no significant predictable trend.

Support line and Resistance line

Support lines and Resistance lines are the levels that can make the price stop, move, and reverse direction. From the information about uptrend line, downtrend line and sideways trend mentioned above we can construct a support and resistance line.

A Support line is the price level at which a security tends to stop falling because there is more demand than supply.

A Resistance line is the opposite. It's the price ceiling above which it is supposedly difficult for a security to pass due to more supply than demand.

How to use a Trend line

A Trend uses movement as well as momentum. Trend lines are attempts to define price movements and to help identify the end of the trend so as to profit. Charles Dow, who invented the Dow Industrial Average and many of the concepts of charting, considered that the market as a whole was at any time in the grip of three trends: Long-term trends last for months or years, medium-term trends for weeks to months and short-term trends, for days or possibly a few weeks.

Inside long periods of time you can see the major Trend which has many minor trends inside. That's mean in the major uptrend you can see minor downtrends inside and vice versa. The Investor has to understand both the timing and holding period for an investment. When you buy a stock in the uptrend period you should hold until the trend changes, such as if the price violates the supporting line which would mean a Sell Signal. When the price of a security moves upward from the downtrend line, breaking the resistance level that would indicate a Buy signal.

Support becomes resistance and resistance becomes support once the support or resistance is violated. The same principle holds true of trend lines. In other words, an up trend line (a support line) will usually become a resistance line once it's decisively broken. Similarly, a down trend line (a resistance line) will often become a support line once it's decisively broken.

However, all investors should consider the term of the Trend. One chart may predict several things in terms of different periods. One person can look at minute-by-minute charts and another may only look at daily or weekly charts. The investor should determine which term is right for them in making buy/sell decisions. If they use a daily chart for a buy decision, they should also use a daily chart for the sell decision.

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