Bij Investment Consultants

Basics of Technical Analysis

1

BASICS OF TECHNICAL ANALYSIS

Introduction

- The methods used to analyze securities and make investment decisions fall into two very broad categories: **Fundamental Analysis and Technical Analysis**.
- Fundamental analysis involves analyzing the **characteristics of a company** in order to estimate its value.
- Technical analysis takes a completely different approach; it doesn't care one bit about the "value" of a company or a commodity. Technicians (sometimes called chartists) are only interested in **the price movements in the market**.

2

BASICS OF TECHNICAL ANALYSIS

Definition

- **"Technical analysis is the study of market action, primarily through the use of charts, for the purpose of forecasting future price trends."**
- The term **"market action"** includes the three principal sources of information available to the technician- **Price, Volume and Open Interest**. (Open Interest is used only in futures and options.)
- The term **"price action"** which is often used, seems too narrow because most technicians include volume and open interest as an integral part of their market analysis.

3

BASICS OF TECHNICAL ANALYSIS

The Basic Assumptions

- Technical analysis is **a method of evaluating securities by analyzing the statistics generated by market activity**, such as past prices and volume. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns that can suggest future activity.
- The field of technical analysis is based on **three assumptions**:

1. The market discounts everything.

2. Price moves in trends.

3. History tends to repeat itself.

4

BASICS OF TECHNICAL ANALYSIS

The Basic Assumptions

1. The Market Discounts Everything

- A major criticism of technical analysis is that it **only considers price movement**, ignoring the fundamental factors of the company. However, technical analysis assumes that, at any given time, a stock's **price reflects everything** that has or could affect the company - including fundamental factors.
- Technical analysts believe that the company's fundamentals, along with broader economic factors and market psychology, **are all priced into the stock**, removing the need to actually consider these factors separately. This only leaves the analysis of price movement, which technical theory views as **a product of the supply and demand** for a particular stock in the market.

5

BASICS OF TECHNICAL ANALYSIS

The Basic Assumptions

2. Price Moves in Trends

In technical analysis, price movements are believed to follow trends. This means that **after a trend has been established, the future price movement is more likely to be in the same direction** as the trend than to be against it. Most technical trading strategies are based on this assumption.

6

BASICS OF TECHNICAL ANALYSIS

The Basic Assumptions

3. History Tends To Repeat Itself

- Another important idea in technical analysis is that history tends to repeat itself, mainly in terms of price movement. The **repetitive nature of price movements** is attributed to market psychology; in other words, market participants tend to provide a consistent reaction to similar market stimuli over time.
- Technical analysis **uses chart patterns to analyze market movements and understand trends**. Although many of these charts have been used for more than 100 years, they are still believed to be relevant because they illustrate patterns in price movements that often repeat themselves.

7

BASICS OF TECHNICAL ANALYSIS

The Basic Assumptions

Not Just for Stocks

- Technical analysis can be used on any security with historical trading data. This **includes stocks, futures and commodities, fixed-income securities, forex, etc.**
- These concepts can be applied to any type of security. In fact, technical analysis is more frequently associated with commodities and forex, where the participants are predominantly traders.

8

BASICS OF TECHNICAL ANALYSIS

Fundamental Vs. Technical Analysis

- Technical Analysis looks at the **Price Movement** of a security and uses this data to predict its future price movements.

- Fundamental analysis, looks at **Economic Factors**, known as fundamentals.

9

BASICS OF TECHNICAL ANALYSIS

Fundamental Vs. Technical Analysis

Difference:

Charts vs. Financial Statements

- At the most basic level, a Technical Analyst **approaches a security from the Charts**.
- A Fundamental Analyst **starts with the Financial Statements**.
- Technical traders, believe there is **no reason to analyze a company's fundamentals** because these are <u>all accounted for in the stock's price</u>. Technicians believe that all the information they need about a stock **can be found in its charts.**

10

BASICS OF TECHNICAL ANALYSIS

Fundamental Vs. Technical Analysis

Charts vs. Financial Statements

- By looking at the Balance Sheet, Cash Flow Statement and Income Statement, a Fundamental Analyst tries to determine a company's value. In financial terms, an analyst attempts to measure a **company's intrinsic value**.
- In this approach, investment decisions are fairly easy to make - if the price of a stock trades below its intrinsic value, it's a good investment. Although this is an oversimplification (fundamental analysis goes beyond just the financial statements) for the purposes of this tutorial, this simple tenet holds true.

11

BASICS OF TECHNICAL ANALYSIS

Fundamental Vs. Technical Analysis

Time Horizon

- Fundamental analysis **takes a relatively long-term approach** to analyzing the market compared to technical analysis.
- Technical analysis **can be used on a timeframe of weeks, days or even minutes.**
- Fundamental analysis often looks at data over a number of years. Furthermore, the numbers that a fundamentalist analyzes are only released over long periods of time. Financial statements are filed quarterly and changes in earnings per share don't emerge on a daily basis like price and volume information.

12

BASICS OF TECHNICAL ANALYSIS

Fundamental Vs. Technical Analysis

Time Horizon

- Also remember that fundamentals are the actual characteristics of a business.
- New management can't implement sweeping changes overnight and it takes time to create new products, marketing campaigns, supply chains, etc.
- Part of the reason that fundamental analysts use a long-term timeframe, therefore, is because the data they use to analyze a stock is generated much more slowly than the price and volume data used by technical analysts..

13

BASICS OF TECHNICAL ANALYSIS

Fundamental Vs. Technical Analysis

Trading Versus Investing

- Not only is technical analysis more short term in nature that fundamental analysis, but the goals of a purchase (or sale) of a stock are usually different for each approach.
- Technical Analysis is used for a trade. Traders buy assets they believe they can sell to somebody else at a greater price.
- Fundamental analysis is used to make an investment. Investors buy assets they believe can increase in value.

The line between a trade and an investment can be blurry, but it does characterize a difference between the two schools.

14

BASICS OF TECHNICAL ANALYSIS

Fundamental Vs. Technical Analysis

Can They Co-Exist?

- **Fundamental analysts** use technical analysis techniques *to figure out the best time to enter* into an undervalued security. Oftentimes, this situation occurs when the security is severely oversold. By timing entry into a security, the gains on the investment can be greatly improved.
- **Technical traders** might look at fundamentals *to add strength to a technical signal*. **For example**, if a sell signal is given through technical patterns and indicators, a technical trader might look to reaffirm his or her decision by looking at some key fundamental data. Oftentimes, having both the fundamentals and technicals on your side can provide the best-case scenario for a trade.

15

THANK YOU

16