Standard

| TECHNICAL ANALYSIS |

What is Technical Analysis?

It's the study of market action primarily through the use of charts

AS WE DISCUSSED in week five of this series, there are two broad schools of investment analysis: fundamental and technical analysis. We have explored fundamental analysis – finding the intrinsic value of a share through detailed investigation of the economy, industry and company itself – in some detail in the past few weeks. Now we will examine technical analysis: understand what it is, provide a few pointers on how to get started and where to find more information.

Yonatan Rom, CEO of The Winning Edge and a technical analysis expert, describes technical analysis as: "The study of market action primarily through the use of charts for the purpose of forecasting future price trends."

Rom says that technical analysis differs from fundamental analysis in two key ways.

Firstly, technical analysts study market action (that is price) whereas fundamental analysts look at the factors affecting supply and demand. Secondly, technical analysts look at the effects of market movements whereas fundamental analysts look at the cause of market movements. "The pure technical analyst attempts to bypass the uncertainty of fundamental analysis and takes out the ambiguities of what factors are driving supply and demand. It just looks at price action as simply as possible."

The result, as Richard Seddon – head of Online Share Trading at the Standard – points out, is that technical analysis is useful in timing the market when used with other confirming data.

However, Rom says that the two approaches do not invalidate each other and in fact are complementary.

The beauty of technical analysis is that it uses only publicly available share price information to identify trends in share prices and markets. These trends are then used to make investment decisions. As a result, technical analysis can be far more clinical than fundamental analysis and technical traders are less likely to become too emotionally involved with their portfolio and so are more willing to cut their losses rather than hanging on in the hope that the fundamentals will, ultimately, reassert themselves.

The pure technical analyst attempts to bypass the uncertainty of fundamental analysis. **Yonatan Rom**

There are a number of books available on technical analysis for novices interested in pursuing this further. In addition, the process can be simplified – and its accuracy increased – by using technical analysis software. Standard's Online Share Trading customers can download daily technical analysis data at discounted prices through the website www.securities.co.za at R90 a month.

Online Share Trading also offers its clients face-to-face basic and advanced courses on technical analysis for a low fee (R350 for basic and R650 for the advanced.) There's also a free interactive basic technical analysis course available online for Online Share Trading clients.

Thirdly, there's a charting tool available on the website that uses ten years' data.

For those who want to combine technical and fundamental analysis, Online Share Trading has just introduced a new and exciting investment tool called ShareMagic. ShareMagic is a technical (charting) and fundamental analysis package from ProfileData, the same company from which Online Share Trading sources company profiles and research tools for its website. Online Share Trading from the Standard has negotiated a 50% discount for its clients who will pay just R2 995,00 (including VAT) for the software package. This is subject to a 12-month download subscription. Online Share Trading clients also qualify for a discount on the monthly download service fee and pay just R134 a month (including VAT). ¤

The three key concepts of Technical Analysis

FOR TECHNICAL ANALYSTS, it's irrelevant whether a stock is expensive or cheap relative to its fundamentals. The only thing that matters, according to Investopedia.com, is "a security's past trading data and what information this data can provide about where the security might move in future". Technical analysis is based on three key assumptions: the market discounts everything, share prices move in trends and that history repeats itself.

The first key assumption is that "the market discounts everything". Fundamental purists criticise technical analysis on the grounds that it looks only at price movements and completely ignores the fundamental drivers of profitability. However, as Investopedia.com notes: "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."

Secondly, technical analysis is based on the premise that prices move in trends. In a nutshell this means that once a trend in the direction of a share price has been established, the next move in share prices is more

likely to be in the same direction as that trend rather than in a different direction. In other words, if a share price is firmly established in a bull (or upward trend), the share price is more likely to continue increasing rather than decrease in the next trading period. Most technical trading strategies are based on this assumption.

The last key assumption upon which the discipline of technical analysis is built is that history tends to repeat itself, especially in share price movement. Investopedia.com says: "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 analyse 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." ¤

First Steps in Technical Analysis: Charts

TECHNICAL ANALYSIS is the study of market action (in prices), mainly using charts. In this article, we'll discuss what charts are and the different types of charts used by technical analysts.

In simple terms, charts are the basic building blocks of technical analysis. They can provide buy or sell signals to those who know what they are looking for.

Technical analysis charts look exactly the same as any other business-related chart. Investopedia.com says: "A chart is simply a graphical representation of a series of prices over a set time frame. For example, a chart may show a stock's price movement over a one-year period, where each point on the graph represents the closing price for each day the stock is traded." (See graph 1.) The time scale runs at the bottom (or x-) axis, while the share price is shown on the vertical (or y-) axis. Graph 1 shows that this particular share price was R245 in October 2004 (point 1) and rose to R265 in June 2005.

There are two key things to note when you look at a chart: the time scale and the price scale.

According to Investopedia.com, the time scale refers to the range of dates at the bottom of the chart, which can vary from decades to seconds. The most frequently used time scales are intraday, daily, weekly, monthly, quarterly and annually. The shorter the time frame, the more detailed the chart. Each data point can represent the closing price of the period or show the open, the high, the low and the close depending on the chart used.

The second key thing to note is the price scale on the right hand side of the chart. The price scale moves from low prices to high prices, but the catch is that it can be constructed using either a linear (or arithmetic) or logarithmic scale.

Investopedia.com notes: "If a price scale is constructed using a linear scale, the space between each price point (10, 20, 30, 40) is separated by an equal amount. A price move from 10 to 20 on a linear scale is the same distance on the chart as a move from 40 to 50. In other words, the price scale measures moves in absolute terms and does not show the effects of percentage change. If a price scale is in logarithmic terms, then the distance between points will be equal in terms of percentage change. A price change from 10 to 20 is a 100% increase in the price while a move from 40 to 50 is only a 25% change, even though they are represented by the same distance on a linear scale." A logarithmic chart shows you the percentage move in a share price, which is what investors are interested in.

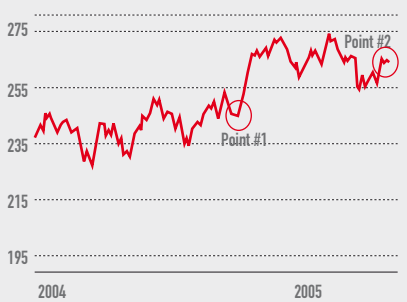
These two concepts are illustrated in graph 2.

From this basic discussion, let's look at the four most common types of technical analysis charts and what they're used for. The chart types are: the line chart, the bar chart, the candlestick chart and the point and figure chart.

Investopedia.com says: "The most basic of the four charts is the line chart (graph 3) because it represents only the closing prices over a set period. The line is formed by connecting the closing prices over the time frame. Line charts do not provide visual information of the trading range for the individual points such as the high, low and opening prices. However, the closing price is often considered to be the most important price in stock data compared to the high and low for the day and this is why it's the only value used in line charts."

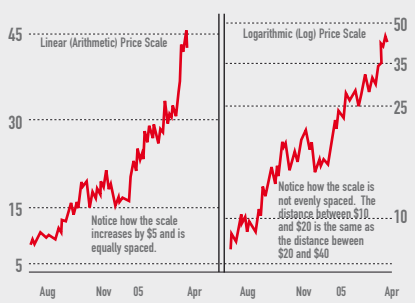
The second type of chart is the bar chart (graph 4). Investopedia.com says it's an improvement "on the line chart as it adds several more key pieces of information to each data point. The chart is made up of a series of 4 »

GRAPH 1: BASIC SHARE PRICE CHART



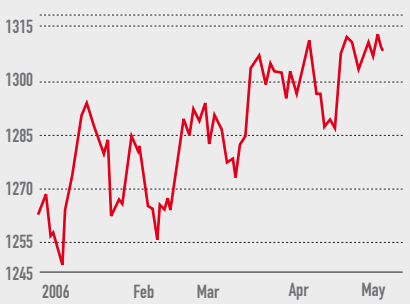
Source: Investopedia.com

GRAPH 2: PRICING SCALES



Source: Investopedia.com

GRAPH 3: LINE CHART



Source: Investopedia.com

2 «

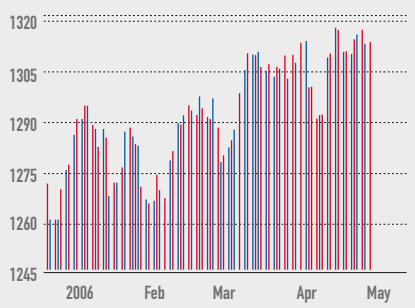
vertical lines that represent each data point. A vertical line represents the high and low for the trading period, along with the closing price. The close and open are represented on the vertical line by a horizontal dash. The opening price on a bar chart is illustrated by the dash that's located on the left side of the vertical bar. Conversely, the close is represented by the dash on the right. Generally, if the left dash (open) is lower than the right dash (close) then the bar will be shaded black, representing an up period for the stock, which means it's gained value. A bar that's coloured red signals that the stock has gone down in value over that period. When this is the case, the dash on the right (close) is lower than the dash on the left (open)."

Thirdly, technical analysts commonly use the candlestick chart (graph 5). Investopedia.com says, it "is similar to a bar chart, but it differs in the way that it's visually constructed. Similar to the bar chart, the candlestick also has a thin vertical line showing the period's trading range. The difference comes in the formation of a wide bar on the vertical line, which illustrates the difference between the open and close. And, like other charts, Candlesticks also rely heavily on the use of colours to explain what has happened during the trading period."

Candlestick charts use different colours depending on whether a share price increased or fell in a trading day.

The last commonly used chart is the point and figure chart (graph 6). According to Investopedia.com: "This type of chart reflects price movements and is not as concerned about time and volume in the formulation of the points. The point and figure chart removes the noise, or insignificant price movements, in the stock, which can distort traders' views of the price trends." ¤

GRAPH 4: A BAR CHART

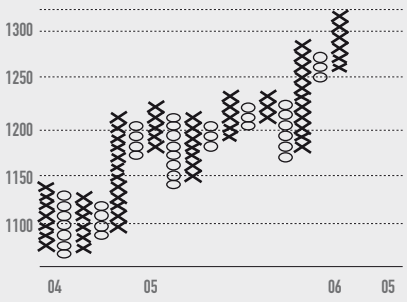


Source: Investopedia.com

CHART 5: CANDELSTICK CHART

Source: Investopedia.com

GRAPH 6: POINT AND FIGURE CHART



Source: Investopedia.com

The Advantages of Technical Analysis

ALTHOUGH TECHNICAL ANALYSIS can appear to be incredibly complicated and not for the "fundamental investment purist", it does have some advantages over fundamental investment analysis.

Yonatan Rom, CEO of The Winning Edge, says that technical analysis has three key advantages over fundamental analysis.

The first key advantage of technical analysis, according to Rom, is that it can be adapted to any trading medium or time horizon. Technical analysis can be used on any financial security with a trading history, including shares, unit trusts, commodities, foreign exchange, fixed income securities or futures.

In addition, technical traders can change their investment horizon to whatever they want as you get daily, weekly, monthly or intraday charts that can go from minute-to-minute or 30-minute charts.

The last key advantage of technical analysis over fundamental analysis is that investors can look at any market instead of just focusing on a narrow range of investment instruments as fundamental analysts do, which can be very time-consuming.

Technical analysis is an important tool in the investor's arsenal and is increasingly used by both professional and personal investors to aid in making and timing investment decisions. ¤

QUIZ

EACH WEEK we'll publish three questions related to the week's content. At the end of the 12 weeks Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To take part in the draw just answer the following questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

1. What is technical analysis?
2. What are the three key concepts of technical analysis?
3. What are the building blocks of technical analysis? ¤

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