Technical Analysis

Getting acquainted with technical analysis

Technical analysis attempts to forecast stock prices and market trends by analyzing their past behavior. It looks not at a company as a business but at the company's stock price and how it's affected by supply and demand like any other product. It attempts to identify trading patterns by relying heavily on computer-generated charts that show price history and the volume of trading in a particular stock.

One of the most common sayings in the investment world is that past performance is no guarantee of future results. However, investors who use technical analysis believe that looking for past patterns and trendlines in stock prices can help them identify future trends. For example, they try to identify at what point a rising stock price will meet with resistance from investors and stop going up, or the point at which falling prices may find support from buyers. Charts may show price movements within a single trading session (intraday) or cover days, weeks, months, quarters, or years. Part of the challenge of technical analysis is trying to identify which indicators and which patterns might shed light on future price movements.

People who primarily use technical analysis to evaluate a stock or a particular market index often do so because they want to profit from short-term price swings. Unlike fundamental analysis, which uses data that doesn't change as frequently, technical analysis is most suited to investors who want to spend a lot of time and attention on monitoring price changes in their investments. A technician or chartist mentality tends to be that of a trader rather than a long-term investor. Few investors rely solely on technical analysis, and outright skeptics believe it is of no more value to successful investors than a crystal ball. However, many investors use aspects of both technical and fundamental analysis.

Technical indicators

The computer-generated charts used by technicians are based on formulas calculated with information about a stock's price history or trading volume. Those formulas are known as technical indicators, and are used to try to quantify investor attitudes and behavior. Traders often compare multiple indicators to try to confirm any trend they perceive in a single indicator. For example, someone who feels a stock's moving average is issuing a buy signal might also check its trading volume to see whether widespread investor interest indicates the price movement is strong and likely to be sustained.

Put-call ratio

The put-call ratio attempts to quantify whether investors believe the market or an individual stock's price will drop. A high ratio of puts to calls indicates that investor sentiment is largely pessimistic. People who are buying puts, because they believe prices will fall, outnumber the people buying calls, who believe prices will rise.

Moving averages

These are averages of security or stock prices computed over time. The most common is the 200-day moving average; the 50-day moving average shows more recent price history. When a stock price falls below its own moving average, some technicians tend to view it as a sell signal. Likewise, a price movement above the average may be viewed as a buy signal. Moving averages are represented by straight lines that help smooth out day-to-day chart patterns. By looking at the number of stocks trading above or below their moving averages, analysts can get a sense of how the market as a whole is behaving.

One popular technique used with moving averages is called Bollinger bands. Technicians draw lines above and below the moving-average line; these lines define the stock's typical trading range based on volatility over time. The narrower the band between the two lines, the more stable the trading range is; the wider the band, the more ups and downs in the stock's price.

Volume

Volume represents the total number of shares traded in a given period of time. It can help determine whether a stock's price movement is based on only a few trades or broader interest. A large deviation from normal volume may indicate a change in the demand for (or supply of) the stock. Technicians often use volume figures to estimate the size and strength of an anticipated change in a stock's price trend. For example, if a stock's price is rising but trading volume is low, that may suggest relatively weak support for the stock at the higher price.

Relative strength

This figure attempts to measure investor interest in a stock by comparing the average of the number of days a stock's price closes higher over a given period to the average of the number of days it closes lower over the same period. Relative strength is a component of another statistic known as the relative strength index (RSI). RSI attempts to quantify whether a stock is overbought and ready to come down, or is oversold and therefore a bargain.

Momentum

Momentum measures how quickly a stock's price is changing. A technician first looks at the difference between a stock's price on two different days--for example, 10 days apart--and then charts a rolling average of that 10 days' price differential over multiple days, weeks, months, or years. The resulting line showing that rolling average can indicate whether price trends are accelerating or slowing down.

Some common patterns in technical analysis

Many investing theories purport to identify and explain patterns in stock prices that can be used to buy or sell a stock at the best possible time to profit from major short-term price changes. Technical patterns often are described by their visual appearance on a chart. It sometimes seems as though there are almost as many technical patterns as there are investors doing technical analysis. Here are some of the more widely known patterns that technical analysts attempt to spot.

Triangle

This pattern includes one line drawn along the highs of a stock's price chart and another along its lows. The two lines show the range in which a stock has been trading. Technicians searching for this pattern look for a bottomless triangle with its apex on the right. Technicians believe that as the range of prices narrows toward the point of the apex, a stock price that manages to move outside the triangle is more likely to experience a sharp move up or down. That move is called a breakout if the price goes up, or a breakdown if it drops. Triangle patterns can be symmetrical, ascending, or descending. They sometimes are considered an example of a continuation pattern, which is said to help identify or confirm the stock price's overall direction.

> **Caution:** One of the challenges of looking for chart patterns is distinguishing a continuation pattern from a reversal pattern, which is said to predict a major shift in the stock price's overall direction. Even technical analysts sometimes disagree about whether a triangle pattern signals a continuation or a reversal.

Flag

A flag pattern occurs when a stock trades in a narrow range of prices. Parallel lines--one drawn along the highs on the price chart, one drawn along its lows--slope against an overall upward trend line, much as a flag might drape slightly from a flagpole.

Cup and handle

This pattern is characterized by a U-shaped price movement that looks like a cross-section of a cup, followed by a slight downward movement that forms the cup's handle. Typically, it is said to occur when a stock's price has been rising. Another U-shaped chart, called a saucer, has a shallower U and no handle; it is said to occur when a stock's price has been declining.

Head and shoulders

The head-and-shoulders pattern occurs when a stock's price hits a peak, declines, rises again to a higher peak that resembles the head, declines again to the so-called neckline level, then rises to a third peak that is not as high as the second peak. A price drop from that second shoulder often triggers orders from short sellers who believe the pattern indicates the price will drop further.

The head-and-shoulders pattern is one example of a reversal pattern, which is said to mark a major change from an upward trend to a downward trend--or vice versa--in a stock's price.

Double bottom

Another reversal pattern, which resembles a W, is said to occur when a stock's price drops, bounces back significantly, drops again to the previous level, and then turns up again with strong buying volume. The two bottoms are said to represent a support price for the stock and signal an upturn if there is sufficient buying volume on the final move up. Technicians also watch for a triple bottom, used to predict a reversal to a longer-term upturn.

Double top

This is the mirror image of a double bottom. It resembles an upside-down W and is used to forecast a significant downturn. In this case, the support level is considered the trough between the two highest prices; if the price drops below that support trough and the volume of trading in the stock is high, traders may take a short position, believing that the price is headed down even further. Just as there can be triple bottoms, there also can be triple tops that are said to predict a long-term reversal from an upward trend.

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