

Technical Analysis: Fuhgeddaboudit

I realized technical analysis didn't work when I turned the charts upside down and didn't get a different answer.

—Warren Buffett

There are three roads to ruin: women, gambling, and technicians. The most pleasant is with women, the quickest is with gambling, but the surest is with technicians.

—Georges Pompidou

Admit it. You were as surprised as I was to find that the former President of France said something about technical analysis. Perhaps it illustrates that individuals who have even a casual interest in the stock market are more likely using a technical approach of some sort. Usually it comes via charts because charts, tables, and graphics are, after all, part and parcel of our daily life. It is easier to show a chart on *CNBC*, *Bloomberg*, or in *BusinessWeek* than GM's balance sheet or income statement. Most market letters are technical in nature, claiming to provide guidance and clarity by reducing all required inputs to a simple, concise graph or table.

Unfortunately, neither life nor the stock market is that simple. We contend after years of analysis and experience that *technical analysis* does not work.

It is not predictive, it is not consistent, and it is not analysis. While we may not go so far as to compare it to a snake oil salesperson or three-card Monte players, in the ultimate test—making money—it fails.

It fails for a variety of reasons. To begin, it is not a discipline. Unlike the more traditional, fundamental analysts who begin with the economy, examine industries, and eventually look at individual stocks, the technical tool kit is a vast array of approaches and ingredients.

At one recent seminar, the speaker provided a list of technical elements:

Charts: Line & Ratio	Technical Studies: Oscillators
Bar Charts	Trending
Candle Patterns	Price Pattern Analysis
Point & Figure	Psychology
Market Picture	Fibonacci
Kase Charts	Dow Theory
TBL Charts	Cycle Theory
	Elliott Wave Theory
	Sector Rotation
	Sentiment
	Breadth

This list is by no means complete. Over the years, the stock market has been “forecast” by astronomy, musical lyrics, any number of statistical/mathematic approaches, and, lest we forget, the Super Bowl. We would be remiss not to mention an article in *Playboy*: “How to Beat the Stock Market by Watching Girls, Counting Aspirin, Checking Sunspots, and Wondering Where the Yellow Went” (July 1973).

In mid-2010, investors were warned about the ominous signals coming from the Hindenburg Omen:¹

Over the past week, the amount of media coverage given to a rather obscure conglomerate of technical signals called “The Hindenburg Omen” has been extensive . . . it is supposed to be a very bad sign for the stock market.

The word “crash” is frequently found in the Omen forecast.

A *Wall Street Journal* blog later reported “Yep, it was a dud”, and the market, rather than crashing, cracking, or correcting, gained 22 percent through year end (see Figure 1.1).

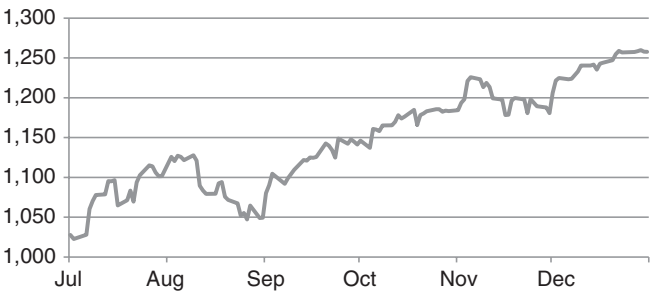


FIGURE 1.1 S&P 500: 2H 2010
Source: Birinyi Associates, Inc., Bloomberg.

INDICATORS: PICK ONE, ANY ONE

The technical analyst/chartist has therefore an abundance of options. Our contention is that too often the facts or indicators support a conclusion; if the indicator changes, no problem, another approach (bearish or bullish) or indicator is inserted.

One approach that we would endorse is to have a consistent process, perhaps beginning with an analysis of the 30 stocks in the Dow Jones Industrial Average (DJIA). A manageable sample that could be regularly analyzed and then supported by some of the other elements listed previously.

Unfortunately, one such exercise only reinforces our argument that technical efforts are of little value. Some years back, *Barron's* asked three chartists to review the 30 individual stocks that comprise the DJIA:

The first reported that it was indeed "a classic long-term bull" and expected 2,410–2,825 for the rest of the year with an upside target of 3,400–3,425 "possible" over the next twelve months.

The second was a bit more cautious: "supporting one more move into new high ground" with the possibility of a "more serious down" turn in the Spring.

The third felt that eighteen names were bullish with six others neutral. "During the current quarter . . . test the Dow's intraday high of 2,745." After that "could rise above 3,000" in the first quarter of the next year.

Unfortunately, for investors and analysts alike they were woefully wrong.

October 12, 1987

Analyzing the Dow

Three Top Technicians Size Up the 30 Industrials

Figure 1.2 illustrates and articulates one of our concerns regarding the approach: *Technicians have a disappointing record at critical junctures.* This applied not only in 1987 but regularly and, sadly, increasingly so.

The 1987 Crash marked the end of the great Volcker rally, which began August 12, 1982 and saw the S&P gain 229 percent. At its birth, at another critical juncture, the technical community was also AWOL. It is interesting to review the mood of those times, while the stock market was technically, in a bear market, it was to be a relatively mild decline (losing 24 percent). But the economy was in a recession (which ended in November 1982) and a number of economists suggested that *depression* might better describe

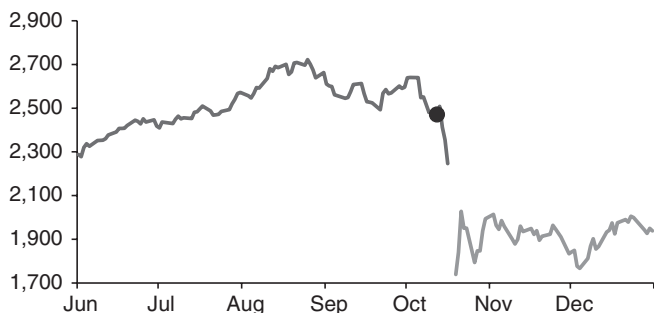


FIGURE 1.2 DJIA: 1987

Source: Birinyi Associates, Inc., Bloomberg.

the landscape. Inflation made investors wary of bonds, even as the 30-year Treasury was yielding 14 percent.

The inflation concern was dramatized in the infamous *BusinessWeek* cover, “The Death of Equities,” shown in Figure 1.3.

Ironically, the magazine was not an inflection point or buy signal, as it was actually published during a bull market (see Figure 1.4).

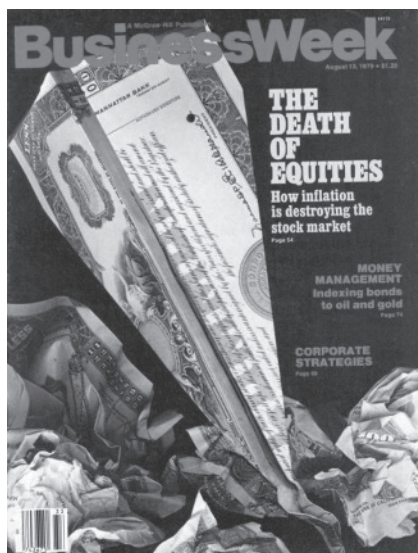


FIGURE 1.3 *BusinessWeek* Cover (August 13, 1979)

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FIGURE 1.4 S&P 500: 1974 Bull Market

Source: Birinyi Associates, Inc., Bloomberg.

Less notorious was *Forbes'* response with their cover "Back from the Dead?" (September 17, 1979).

While the rally's catalyst was Dr. Henry Kaufman's comments on August 17, 1982, the market had actually bottomed the previous Thursday. Over the intervening weekend, a lengthy *New York Times* article detailed the views of several technical analysts:

Dark Days on Wall Street

The long bear market seems to be entering its final phase. The end could be violent but also cathartic.

A prominent technician argued that the market must first capitulate "... a time when everybody simply gives up." He suggested a final sell-off could come by November, maybe sooner, and the next six months would be critical.

Joe Granville, the most visible member of the community, suggested 550 to 650 by January.

On Tuesday, August 17, the DJIA rose 38.79 or 4.9 percent and traded 92 million shares (the average of the previous 50 days had been 53 million shares). On August 18, a new record, and the first 100-million share day saw volume rise to 131.6 million shares. Despite the gains and activity, chartists were generally unimpressed:

... the Dow could well break its '82 low.

... an even lower Dow reading, about 680, is anticipated by the end of the month by Justin Mamis, a well-regarded technical analyst.²

One month later, John Schulz wrote a piece for *Barron's* on September 13, 1982:

Messing Up the Tea Leaves, Where Technical Analysis Went Wrong

Why did so many pros fail to see it coming? Technical analysis must shoulder much of the blame . . . [technical analysis] offered monumentally bad advice just when—for perhaps the first time in modern history—it finally proved decisively instrumental in shaping majority opinion.

Schulz wrote that the technicians were unanimous in their view that a bottom would be accompanied by “waves of massive selling.” Cash was not at expected bear market levels, and sentiment readings likewise failed to reflect an overwhelmingly negative view. He also suggested that the bearish indicators had become too popular and accepted and therefore discounted.

1990: ANOTHER OPPORTUNITY MISSED

If the chartists were negative in 1982, their attitude in 1990 was even more pronounced (see Figure 1.5). Following Saddam Hussein’s foray into Kuwait on August 2, 1990, the market took a sharp, concentrated dive that many expected to be protracted and painful.

Since the decline was event-driven and abrupt, one cannot fault analysts—technical or otherwise—for failing to anticipate the drop. But

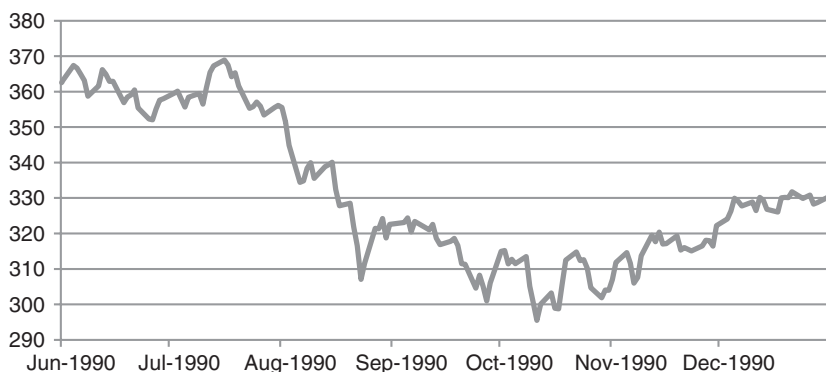


FIGURE 1.5 S&P 500: 2H 1990

Source: Birinyi Associates, Inc., Bloomberg.

their reaction afterward is further evidence of our concern that at critical instances, the approach is unsatisfactory:

Analysts Are Reading Their Charts—And Weeping

With virtually every major indicator pointing south, the market slump may stretch well into next year. . . .

How low is low? Some see the Dow touching bottom at 2,200 . . . or 1,700 . . . or 1,444.

BusinessWeek, October 8, 1990

A Bear-Market Rally? It Sure Looks Like One

. . . watches for three signals that would indicate more than just a bear-market rally. Right now he can't detect evidence of even one. . .

Jack Solomon, technical analyst at Bear Stearns, puts things bluntly. The first rallies don't hold. Sell them . . . it's a trap.

Wall Street Journal, November 21, 1990

Analysts: Shades of Nostradamus

On December 24, 1990, after the market had gained 11 percent off the bottom, *Barron's* interviewed four analysts.

The first expected a "slide toward 2,400 and then a modest recovery to 2,700–2,800." The second was looking for gains late in 1991 after trading to the 2,100–2,200 level. Analyst number three also thought 2,100 was the next stop followed by a rally to 2,700.

The fourth was the most bearish (2,000, "maybe 1,900") and then trade in the range of 2,000 to 3,000 over the next four or five years (see Figure 1.6).

At the end of the year, the best we can say about these calls is that they tried (see Figure 1.7).

The Market May Be About to "Start Acting Ugly"

. . . technicians are widely predicting grim tidings for the market . . . some analysts are warning of a possible reprise of the events of 1987.

The market traded a bit lower in November/December (–6.9 percent) so once again the bears were in full cry:³

Watch Out for Falling Bulls

Wall Street's technicians are trumpeting a horrible crash—again.⁴

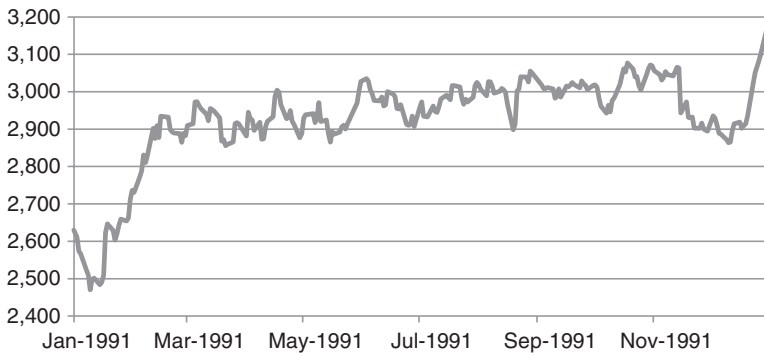


FIGURE 1.6 DJIA: 1991

Source: Birinyi Associates, Inc., Bloomberg.

(These articles were full-page features, not small, insignificant stories relegated to the bottom corner of a page.)

We cited Mr. Buffett earlier. One indicator that is often cited is the weekly sentiment of the American Association of Individual Investors (AAII). Figure 1.8 shows the chart for the 2009 bull market.

Figure 1.9 is the same chart but inverted. As the gentleman from Omaha said . . .



FIGURE 1.7 DJIA: 2H 1991 through 1995

Source: Birinyi Associates, Inc., Bloomberg.

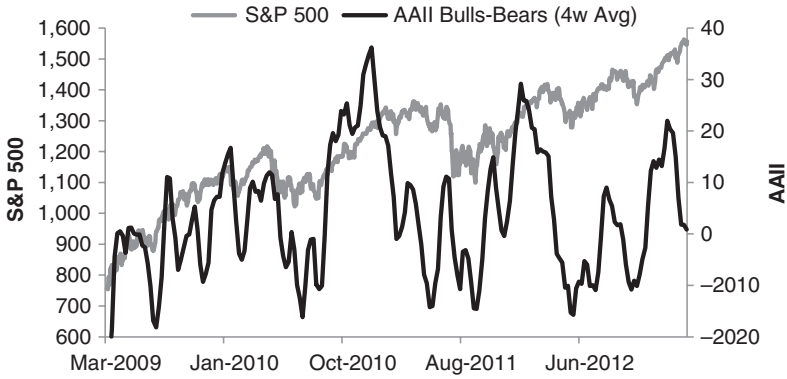


FIGURE 1.8 AAI versus S&P 500

Source: AAI, Birinyi Associates, Inc., Bloomberg.

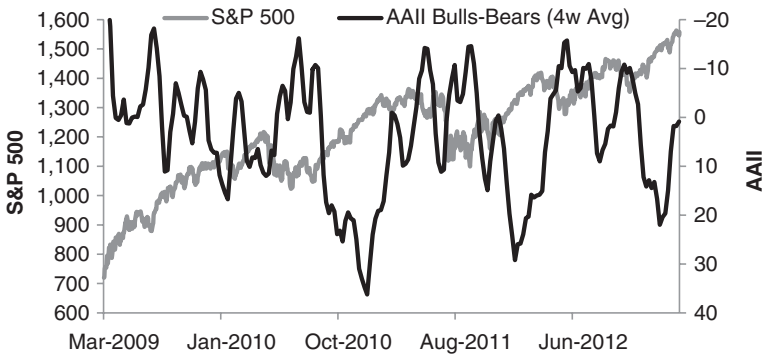


FIGURE 1.9 AAI versus S&P 500 (Inverted)

Source: AAI, Birinyi Associates, Inc., Bloomberg.

NOTES

1. Michael Kahn, "Taking Stock of a Scary Market Signal," *Barron's*, August 8, 2010.
2. Dan Dorfman, "Stock Rally Washed Away," *Daily News*, August 27, 1982.
3. Gary Weiss, "The Market May Be About to 'Start Acting Ugly,'" *BusinessWeek*, August 4, 1991.
4. Gary Weiss, "Watch Out for Falling Bulls," *BusinessWeek*, December 15, 1991.

