Why Technical Analysis?

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Why would anyone want to learn about technical analysis? If we want to understand how to analyze stocks, shouldn't we concern ourselves with valuation metrics like EBITDA (earnings before interest, taxes, depreciation, and amortization) and price-to-sales ratios? Wouldn't our time be better spent listening to conference calls and digging through balance sheets instead of poring over charts in search of various patterns and formations?

In truth, there is nothing wrong with doing any of the above. Terms such as price-to-sales ratio and EBITDA fall under the auspices of "fundamental analysis." Fundamental analysis can be a useful tool for analyzing investment opportunities. Think of technical and fundamental analysis as two different sides of the same coin.

However, fundamental analysis isn't foolproof. You can learn every nuance of fundamental analysis and include every major and minor fundamental metric in your analysis, but you'll still face this problem: *You'll never know what you don't know*. You can analyze all of the information that is available to you, but you'll *never* know if you possess all of the necessary information.

Meanwhile, somebody out there usually *does* know something that you or I don't know. An investment bank that hires an army of MBAs to crunch numbers and pours millions into research *should* know more than the average individual. The market is not a level playing field, and this is particularly true when it comes to fundamental analysis.

Meanwhile, technical analysts believe that all of the necessary information, including data that may be unknown to the public, is reflected in the chart. The price of a trading instrument should reflect all that is known or knowable about that stock, commodity, or currency.

All of the information is included in the price, even inside information. We don't have to know or understand the information to observe its effect on the price.

How can this be possible?

Let's say that a mutual fund or an investment bank has discovered through its research that stock ABC is wildly undervalued and is a screaming buy. The bank starts buying the stock aggressively.

You might never know what it is they know, or who is buying the stock, but if you look at ABC's chart, you should see the effect of that buying in the form of a rising price. That rising price is trying to tell you something, even if you don't know the reason behind the move. It's not necessary to know who or what is behind every move in the market.

Technical and Fundamental Divergence

Fundamentally, a stock or a currency may appear to be pristine, but if the chart tells a different story, believe the chart. There have been many instances where technical analysis and fundamental analysis told very different stories. On several occasions, this divergence has led to a dramatic conclusion.

For example, back in 2001 a major energy stock began to break down for no apparent reason. Most analysts gave this $60 billion company a "strong buy" or "buy" rating. For six consecutive years, *Fortune* magazine declared it to be "America's Most Innovative Company." The stock had been one of the best performers in the energy sector, quadrupling in price in just three years.

When the stock's price began to slip, and technical support levels began to break, fundamental analysts showed little concern. As the price continued to fall, many fundamental analysts referred to the stock's depressed price as "a buying opportunity," and initiated or reiterated buy ratings on the stock.

The name of that company was Enron. That infamous name is now synonymous with fraud and deceit.

The fundamental analysts who upgraded the stock as it fell believed they possessed all of the information needed to make an informed recommendation. What they didn't know is that the company had fed them false information. The information was worthless, and so was the stock!

During the year 2000, Enron climbed above $84 per share; one year later, the stock had fallen below $1. As a result, lives were ruined, pensions became worthless, and future plans evaporated into thin air.

The fundamental analyst works under the assumption that he or she is receiving complete and accurate information, but there is no way to know for certain that this

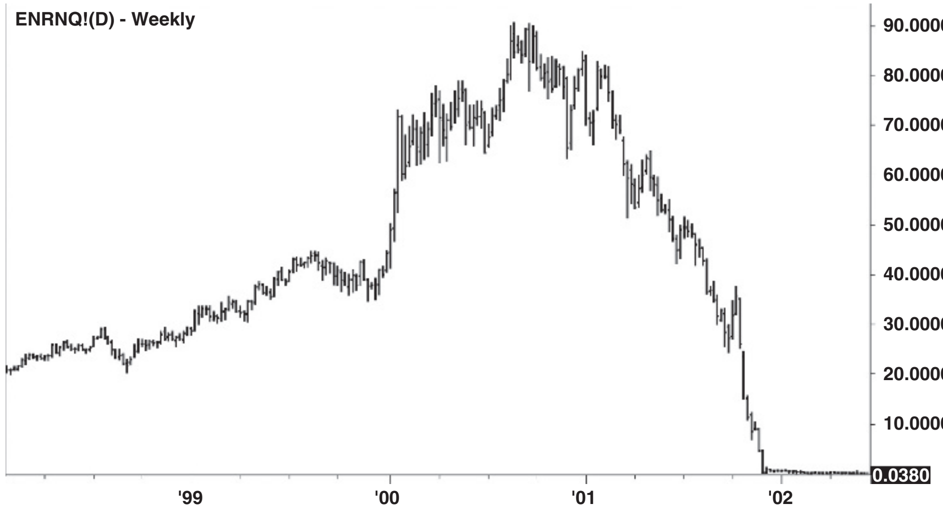

FIGURE 1.1 The Rise and Fall of Enron

is true. However, one look at Enron's chart, shown in Figure 1.1, should have made it clear that something was horribly wrong with the stock. Yet during its decline, Enron executives repeatedly insisted that there were no irregularities. They even encouraged their employees to buy more shares, just before the stock completely collapsed!

As the stock fell, it formed several bearish technical patterns. By the time you've completed this book, you'll know how to understand and apply those patterns should a similar situation arise in the future.

Enron is an extreme example, but it raises an important point: While the executives of the company were lying about the business, and while analysts were basing their assumptions about the company on those lies, the stock's price was telling the truth.

Those who knew the truth about Enron were selling their shares heavily. This is what caused the price to decline so dramatically—the truth was reflected in the stock's price. Any individual trader could have known that there was a problem by looking at the chart—and by ignoring the chorus of fundamental analysts and company officials who insisted Enron was a bargain as it fell.

The Collapse of Lehman Brothers

Another company that confounded analysts under a very different set of circumstances was an investment bank named Lehman Brothers Holdings. Unlike Enron, Lehman Brothers was a legitimate company with a rich history and real profits.

The investment banking company got its start in the 1850s, and by 1887 it was a member of the New York Stock Exchange. By the twenty-first century, it had grown into one of the most successful enterprises of its kind.

During 2007, shares of Lehman Brothers performed extremely well. That year, the stock reached an all-time peak, trading as high as $86.18. The company's shareholders were thrilled with the stock's performance.

Then a severe financial crisis swept the world in 2008, and the company was caught in the storm. The stock began a steep descent. There were persistent rumors that Lehman Brothers was on the verge of insolvency, which the company routinely denied.

During the summer of 2008, those rumors became more persistent, yet company officials never gave any indication to the public that the company was in trouble. The stock's decline accelerated. On September 9, 2008, the Standard & Poor's rating agency put Lehman Brothers on watch for a downgrade, citing its plunging stock price, but at the same time maintained an "A" rating on the stock.

Less than one week later, on September 15, 2008, Lehman Brothers declared bankruptcy. The stock was now virtually worthless. Later that day, Standard & Poor's removed its "A" rating from the stock.

Figure 1.2 depicts the stock's rapid decline. Technical analysts will note that Lehman's chart formed an extremely ominous technical pattern just after the stock reached its all-time peak. This pattern warned technical traders to avoid the stock, even as investors who believed the company's management were buying additional shares.

FIGURE 1.2 The Rise and Fall of Lehman Brothers

Price Is Truth

If fundamental analysts like those at Standard & Poor's had simply focused on the stock's price, they would have noticed a distressed chart that was breaking at all of its major support levels. One glance at that chart proved to be worth much more than countless hours of so-called expert analysis and number crunching.

Think of all the misery that could have been avoided by simply paying attention to that chart. Just as with Enron, Lehman Brothers' employees were heavily invested in the company's stock, particularly in their retirement accounts. Perhaps fundamental analysts should obtain at least a cursory knowledge of technical analysis to use as a filter or warning system in the event of situations such as these.

Years later, shares of Lehman Brothers Holdings are available on the over-the-counter market for less than three cents per share. Both the Lehman Brothers and Enron charts contained numerous clues as to what was about to transpire, thereby warning investors of the danger well before it happened. Fortunately for some investors, technical analysis allowed them to ignore the denials of management and focus on the truth of price.

Similar issues can arise at any time, with any investment, in less dramatic ways. At any given moment, your fundamental analysis of a company may be missing an important piece of information, either positive or negative. How will you know? The sad fact is, you'll only know in hindsight what you didn't know when it mattered most.

On the other hand, if you can read a chart, there's no need to understand the reason behind every move in the market. The price is already telling you everything you need to know.

Which Technical Analysis Method Will Work Best for You?

What is the best way to trade? Which technical analysis method should you use? How can you know which techniques will work best for you?

Everyone wants to know if there is one particular technical analysis method that works better than the others. It's a great question, because a simple answer could save a lot of time and effort.

Unfortunately, there is no simple answer. Nobody can tell you which technical analysis method will work best for you. Only you can make that determination. Here's why:

In *The Little Book of Market Wizards*, author Jack Schwager wrote the following:

> Traders must find a methodology that fits their own beliefs and talents. A sound methodology that is very successful for one trader can be a poor fit and a losing strategy for another trader.

How can that be? How is it possible that a trading strategy can work for one person and not another?

In that same book, Schwager interviewed a hedge fund manager named Colm O'Shea, who elaborated on this concept:

> If I try to teach you what I do, you will fail because you are not me. If you hang around me, you will observe what I do, and you may pick up some good habits. But there are a lot of things you will want to do differently. A good friend of mine, who sat next to me for several years, is now managing lots of money at another hedge fund and doing very well. But he is not the same as me. What he learned was not to become me. He became something else. He became him.

As a trader, you need to become you. How can you accomplish this? Study the various techniques in this book with an open mind. Consider that any of them may or may not work for you. Most likely, one or more of these concepts will resonate with you. Begin your search there.

Once you have found something that makes sense to you, apply it to your personal trading style, which will continue to evolve over time. Gain as much experience as you can, while taking as little risk as possible. After the initial excitement wears off, traders normally become less frantic and more patient. Circumstances change, people mature, and you'll find that your trading style will evolve with experience. The initial thrill of trading is gradually replaced with a calm focus.

This is important, because if you're highly excited while placing trades, you're much more likely to make a serious mistake. How would you feel about being the passenger in a vehicle whose driver is extremely emotional and excited? Or, would you want to glance up from an operating table and notice that the doctor who is about to perform surgery on you is very animated or agitated?

My trading styles have been documented in the books *Forex Patterns and Probabilities* and *The Ed Ponsi Forex Playbook*. Those styles are geared toward currency trading, but many traders have adapted them to stocks and commodities as well. However, as Mr. Schwager and Mr. O'Shea point out, there is no promise that a technique that works for one person will also work for another.

There's a good chance you will find something in this book that resonates with you. Just as important, you need to determine which techniques are incompatible with your personality. Read through the different methods, examine the charts, and sort through the various concepts presented in the following pages. At the very least you'll be able to eliminate some methods, and that's a start.