

What works? What doesn't?

In a sideways market, technical analysis offers an edge

Mazhar Mohammad

Of late, financial markets across the globe have wreaked unprecedented havoc on investors. Right from the little guy in the street to the big professional money managers of the Wall Street, everybody is caught on the wrong foot and searching for a holistic approach, which can help steer through the recession. The questions being asked are: What works in the market? Which form of analysis guides investments better? Is fundamental analysis better or should one go by technical analysis.

Fundamental analysis
This form of analysis has been the cornerstone of investment analysis for decades. Its genesis can be traced to the publication of security analysis by Benjamin Graham and Prof Dodd of Columbia University in 1934. Their work gave birth to the concept of value investing.

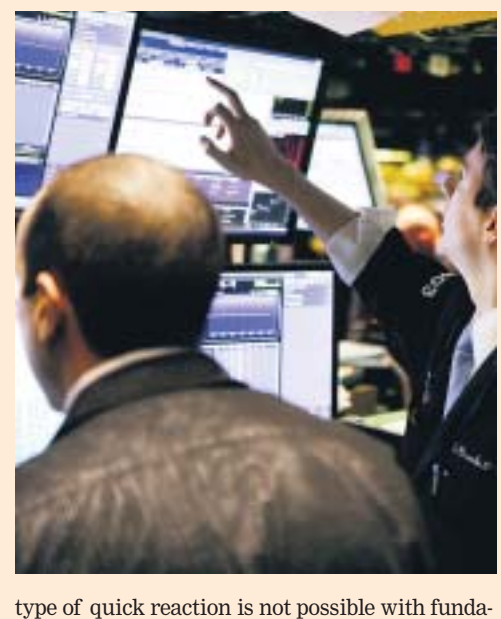
This form of analysis is popular with the Oracle of Omaha (Warren Buffett).
Fundamental analysis involves studying financial statements like balance sheet, profit and loss account, cash flow and debt. The focus is on whether the share price of a company is positioned vis-a-vis its share price. These analysts study macro trends in the economy and try to analyse its

impact on a particular sector or a company in turn. The accuracy of this form of analysis depends on the accuracy of the data. If the source of the data is not reliable, it will lead to another Satyam or Enron kind of fiasco.

But, does the market react to this type of data analysis? Unfortunately, the answer is 'no'.
So what drives the markets? Edson Gould, who worked as a technical analyst in the USA in the 1920s, offers an answer: "Stocks sell at the price not because of any systematic evaluation of their network, but because of what mass investors think they are worth." Thus it is the perception of the masses which determines the price.

One aspect of technical discipline is to explain the gap between the valuations and the current market price. If the value of stock 'x' is Rs 100 on the paper, based on discounted cash flows, projected growth and overall economic conditions, why is it trading at Rs 120? The difference lies in the market perception of the stock. Investors pushed up the price based on their expectations. It may be the reason why tech companies were quoting at three-digit price earning multiples in 2000, irrespective of their fundamentals. It may be the reason why market cap eroded by one-third in a single day in October 1987 crash of Dow despite no drastic changes in the world fundamentals.

Technical analysis
As people's perceptions change quickly, traders react quickly to take advantage of such situations. This



stocks, there was at all times a general trend of the market as a whole. Dow's expression of market behaviour was only through his editorials written during the period of 1900-1902. After his death in 1902, his observations were refined and given a shape by his successor at Wall Street Journal, William P. Hamilton, who authored the mammoth *Stock Market Barometer* in 1922. The collective market wisdom of the duo later came to be known as Dow Theory, which became the grand daddy of technical analysis.

After the demise of Charles Dow, the subject was picked up by Schabacker, who is widely regarded as the father of technical analysis. This young man held prestigious editorial positions during the 1920s and 1930s with influential publications such as the *Forbes* magazine and *The Analyst*, which is the weekend section of New York Times. Schabacker's works include *Stock Market Theory and Practice* (1930); *Technical Analysis and Stock Market Profits*; A course in forecasting (1932); and *Stock Market Profits* (1934).

In contrast to fundamental analysts, a technical analyst especially focuses on the study of historical price behaviour of individual securities. A technician is not worried about financial statements or other economic data. He works on the assumption that market follows everything in advance. This is the reason we find markets not reacting after particular event has happened. Most of the time, the market factors this news, thereby

giving an advantage to the technical analyst.

By studying the historical price relationship, a technical analyst tries to identify turning points as investor behaviour is repetitive in nature given similar circumstances. He also studies indicators and oscillators (which are price derivatives), supports (areas where buying is expected) and resistances (areas where selling is expected), trend line studies, chart patterns like triangles, rectangles, flags, head and shoulder, etc. Explaining these concepts is beyond the scope of this article.

Technician has an edge

The knowledge of technical analysis comes to the rescue of investors/ traders in the sideways markets such as the one witnessed during 1966 to 1982 in Dow Jones or our own Sensex movement from 1992-2000 with significant price swings. Whereas the buy and hold guys will play the role of spectators as they can't react to these short-term price swings based on fundamental analysis.

None of the above approaches is infallible. Each method has its own pros and cons. Many will swear by fundamentals and an equal number will stand by technicals. Investors shall not leave their circle of competency and stick to the method they are comfortable with. Nevertheless, a working knowledge of technicals proves handy for anyone who wants to invest his hard-earned savings in the financial markets.

The writer is a technical analyst with Darashaw & Co, Mumbai.

Just 5 questions

Rajesh Relan, Managing director, MetLife India Insurance

- How do you see the market playing out? Historical trends show that equity markets show a positive trend in the long run, though they may be volatile in the short run.
- What do market movements say about the India story? Indian equity markets do take a cue from the global, regional and domestic factors, but India's long-term structural growth story is very much intact.
- How do you see investor behaviour changing? There is a stronger focus on asset allocation instead of trying to time the markets.
- Will insurance flows especially through products such as Ulips be affected by this? Insurance products are perceived as longer-term investment. The reasons for taking life insurance, i.e., wealth creation, children's education, protection and retirement — these needs will not change due to the volatile economic condition. The volatility, we perceive, is more like a blip.
- What advice would you give investors? Avoid trying to time the market. The most reliable way to earn superior returns is to stay invested in the market for a fairly long time.

...Benoit Mandelbrot's views for the latter

The technical analyst aims to achieve results, not delve into causes

Vijay L Bhamwani

This piece is inspired by the work of Benoit Mandelbrot (and confirms what I have always known — technical works). There are two ways one can track, analyse and trade the financial markets — fundamental analysis and technical analysis. Unfortunately for technicians, broader markets view this school of thought with trepidation. The biases against technical analysis:

● Past price patterns are used to predict future prices, whereas markets are a random walk event. The past has little or no bearing on the prices in the future.

● Since technical analysis assumes that 'everything is factored into the price', using past data means technicians are living in the past and splitting hairs on events that are gone and over.

● Most patterns are an exercise in self-fulfilling prophecies. As more and more people use the same software/tools, the patterns assume significance as more and more people follow such events.

● Technical analysis is based on non-scientific tools and therefore not a pure science. Since no academic/uniform benchmark exists, it cannot be pursued as a career.

● Technical analysis cannot be equated with coin tossing, which is a game of pure chance. Since humans (with emotions) are involved in trading, the closing prices of a session do tend to have a "memory effect" on the opening prices of the next session/s. This is especially true when traders have "open" positions brought forward from previous sessions.

■ Using fractal analysis, Mandelbrot has proved that spikes in prices are followed by periods of high volatility. This is similar to the fat tails flanking the bell curve. This proves that market actions are not totally random in nature. Volatility tends to occur in tight clusters when traders tend to converge on the open/inflation points.

■ Technical analysis is surely not a pure science but a combination of art and science. Since prices are impacted by mass emotions (which are anything but rational), judgment and experience is required to achieve success. These attributes cannot be taught in classrooms from standard textbooks.

■ The future price activity can be projected using past data like changes in buying strength, tick size per trade and market profile of the participants. Technical analysis, to that extent, plays on probabilities.

■ Fundamental analysis employs past data (quarterly/annual reports) for basing future projections. If fundamental analysts were to employ "future" data, I would accuse them of insider trading.

■ What is immaterial is why technical patterns work. What is important is how well they work. If head and shoulder patterns yield profits, technicians pocket these profits rather than ask why.

■ Fundamental analysis can surely be taught in classrooms, but is done so mostly by non-market participants. Technical analysis in contrast is a self-study process, an on the job training exercise where loss-

es are teachers and profits are incentives. Technical analysis of the traders — all practitioners.

■ While fundamental analysis is all about data that emanates from the horse's mouth, the veracity of the data is by no means sacrosanct (remember Satyam?). Technical analysis ignores the "noise" and focuses on what really occurs — higher volumes means higher participation, sudden price spikes, higher open interest, etc. Technical focus on where people are putting their money rather than their mouths.

These arguments seem to tilt the balance in favour of technical analysts, who aim to achieve results rather than delve into the causes.

The writer is an active trader and invites feedback at vijay@bsplindia.com.

STOCKS ON CIRCUIT FILTER				BSE Sensex				INTRA-DAY MOVEMENT				SECTORIAL INDICES				TOP 5 GAINERS & LOSERS				TOP 10 BY TURNOVER NSE				FII & MUTUAL FUNDS																			
Company	H/L	Price	Change	Company	H/L	Price	Change	Company	H/L	Price	Change	Company	H/L	Price	Change	Company	H/L	Price	Change	Company	H/L	Price	Change	Company	H/L	Price	Change	Company	H/L	Price	Change												
BSE																																											
Infosys	1458.00	1458.00	0.00	Reliance Ind	87.40	87.40	0.00	9000		8955.73		NSE		2770		BSE Auto	2874.17	2874.17	0.00	M&M	373.90	373.90	0.00	ICICI Bank	590.13	590.13	0.00	UTI MF	22.82	22.82	0.00	UTI MF	22.82	22.82	0.00	UTI MF	22.82	22.82	0.00	UTI MF	22.82	22.82	0.00
Wipro	1275.00	1275.00	0.00	Hero Cycles	33.25	33.25	0.00	9300		8697.46		INTRA-DAY MOVEMENT		SECTORIAL INDICES		TOP 5 GAINERS & LOSERS				TOP 10 BY TURNOVER NSE				FII & MUTUAL FUNDS																			
Axis Bank	123.00	123.00	0.00	Pfizer	139.00	139.00	0.00	2700	2700	2700	2700	Bank Nifty	3193.10	3193.10	0.00	ITC	136.00	136.00	0.00	ITC	136.00	136.00	0.00	ITC	136.00	136.00	0.00	ITC	136.00	136.00	0.00	ITC	136.00	136.00	0.00	ITC	136.00	136.00	0.00	ITC	136.00	136.00	0.00

TRENDS

Company	% chng	Company	% chng	Company	% chng	Company	% chng
APL	19.51	Aditya Birla	15.75	ICICI Bank	2.27	Wipro	0.00
Axis Bank	2.53	Axis Bank	11.79	ICICI Bank	2.27	Wipro	0.00
Axis Bank	2.53	Axis Bank	11.79	ICICI Bank	2.27	Wipro	0.00

52-WEEK HIGH/LOW

Company	Price	Company	Price	Company	Price	Company	Price
Aditya Birla	15.75	Aditya Birla	15.75	Aditya Birla	15.75	Aditya Birla	15.75
Aditya Birla	15.75	Aditya Birla	15.75	Aditya Birla	15.75	Aditya Birla	15.75

OTHER SECTORS

Company	Price	Company	Price	Company	Price	Company	Price
Aditya Birla	15.75	Aditya Birla	15.75	Aditya Birla	15.75	Aditya Birla	15.75
Aditya Birla	15.75	Aditya Birla	15.75	Aditya Birla	15.75	Aditya Birla	15.75

DELIVERY SPIKE OVER PREVIOUS DAY

Company	Deliv	Pre	Chng	Company	Deliv	Pre	Chng
Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00
Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00

RISING VOLUME, RISING DELIVERY AND RISING PRICE

Company	Traded	Mar 12, 2009	NSE	Traded	Mar 13, 2009	NSE	Traded	Mar 16, 2009	NSE		
Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00
Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00

RISING VOLUME, RISING DELIVERY AND FALLING PRICE

Company	Traded	Mar 12, 2009	NSE	Traded	Mar 13, 2009	NSE	Traded	Mar 16, 2009	NSE		
Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00
Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00	Aditya Birla	15.75	15.75	0.00

Time hourly supports for March 17, 09

Time	Support	Upon violation	Full
09:55 - 10:30	2650	2650	2650
10:30 - 11:30	2705	2672	2638
11:30 - 12:30	2720	2684	2642
12:30 - 13:30	2722	2694	2654
14:30 - 15:30	2738	2696	2654

Trading derivatives is a risky activity. These studies do not assure profits. Please consult a certified financial analyst before trading.

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