IDEA GENERATION FOR THE FUTURE

THE CHURCH OF TECHNICAL ANALYSIS

The Church of Technical Analysis

Early on in my career, I distinctly recall when it was explained to me that there were two ways of thinking when it came to investing.

The first one taught that the investor should focus on fundamental analysis. The exercise involves understanding the key economic drivers of a business model and making estimates about its future. Once the future is determined, the analyst formulates a valuation model to see if a stock is trading at a discount to an intrinsic value. If you find a sufficient margin of safety between the stock's current price and your longer-term estimate, go ahead and key-up a trade. If you're right, the stock price will eventually converge to your price target based on improving fundamentals.

As for the other method, technical analysis, I learned it's all about understanding price momentum, long-term and short-term trends, and incorporating rules of thumb around charts. With this scheme, one need not get into the minutiae of developing financial models for every single company as the behavior of the masses in buying/selling patterns provides enough information to alert you to opportunity or steer you away from a potential problem.

Which is better? The person that outlined both of these to me was a zealous follower of fundamental analysis and thought that pretty much anyone that used technical analysis as one of their investment tools to an extent was a total crack pot. Certainly, I wouldn't want to be one of those people, right? No, of course not.

Over the years, I've come to appreciate this matter can readily stir-up a fight amongst two people who would otherwise enjoy each other's company. The passion around these two schools of thought reminds me of how a good old fashioned argument over religion usually goes down: in the end, winning the argument is more highly prized than actually trying to win a convert.

After a while, I decided I needed to get more information about technical analysis just given intellectual curiosity. Besides, the charts always looked interesting, much like maps, as there's something captivating about them.

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In an attempt to take the potential edge off of the conversation, I jokingly referred to this endeavor with my friends in the industry by saying, "I've been attending a few services at the Church of Technical Analysis." Some people chuckle while the fundamentalists at heart seem at least a bit disarmed.

Where did I begin? I picked-up "Deemer on Technical Analysis." I recommend it. Written by Walter Deemer (2011), his experience is considerable having started at Merrill Lynch in 1963, spent some time at Putnam in the 1970s, left to start his own firm in the 1980s and retired in 2010. The volume is an easy read so don't worry about getting bogged down by jargon or a cumbersome amount of statistics. If that's what you are ultimately looking for, Deemer points you to other resources for those so inclined.

From the way Deemer sees it, technical analysis and fundamental analysis, in so far as they relate to the specific common stocks and to the stock market at large, can properly be regarded as complementary and, in fact, interdependent. The tendency of price trends to persist and of investor's behavioral patterns to recur enables the technical analyst to recognize…"extremes of investor psychology"…and "history never repeats itself exactly, but human behavior does." Technical analysis is one way to observe human behavior.

But can this be used to make money and give an edge to your portfolio? According to Deemer, a technical approach could have been employed to keep you out of market extremes. For instance, if you had been out of the market its 20 worst weeks and also missed out in its 20 best weeks from Jan 1, 1990 to May 20, 2011 (100 weeks) you would be up cumulatively 380% whereas a buy-n-hold investor would only be up 278%.

Idea Generation Continued

Deemer also offered this technical insight when it comes to stock picking, "So all you need to do at the beginning of the new bull market is to buy stocks making new all-time highs…any stock that generates well-above-average long-term relative strength at the beginning of a bull market is very likely to lead the entire bull market."

There are two things you need to know to make this work: 1) identify the start of a new bull market, and 2) pinpoint which stocks are hitting their 52-week highs at that time.

On item one, Deemer notes that a new bull market can be linked to what he calls "breakaway momentum" or a "market breadth thrust." Breakaway momentum occurs when 10-day total advances on the NYSE are greater than 1.97 times 10-day total NYSE declines. According to Deemer's calculations, the last time this occurred was on June 3, 2020. You can find out when he's identified a new bull market by going to his website: https://www.walterdeemer.com/bam.htm

As for the stocks hitting their 52-week highs, you can find them here: https://www.barchart.com/stocks/highs-lows.

Many brokerage accounts now offer substantial tools and screens to help you learn and deploy technical strategies. A word of caution: trading is so cheap nowadays that it's easier than ever to get oneself into a mode of excessive trading. For that reason, make sure you set out your decision rules and put into place proper risk controls. If you don't take time to learn and implement a discipline, the likelihood of inflicting damage to your hard earned savings goes up substantially.

In my view, using fundamental or technical analysis or a combination of both is perfectly fine provided you are disciplined and thoughtful in your strategy. How you are hard wired to accept risk and relate to different kinds of analysis will dictate what is best for you.

Finding an investment strategy that works in all market environments is illusive, but adding some technical analysis into your repertoire if you already haven't done so provides some informative viewpoints worthy of consideration.