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Technical Analysis and the Active Trader

- Shows how to combine technical analysis with behavioral finance
- Exposes flaws in technical analysis and shows how to remedy them
- Improves your technical analysis for better trading

Gary Norden

TECHNICAL ANALYSIS AND THE ACTIVE TRADER

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Challenging the Herd

It was as a result of a combination of factors over the past three or so years that I was actually driven to write this book. First, Nassim Nicholas Taleb's excellent book *Fooled by Randomness* had a great impact on me. I found it a refreshingly different account of the business from the one that is usually described in books, and I believe that it is a must read for anyone who wishes to trade or invest. It was a great relief to me to find that there were other traders who shared similar beliefs, as I have mainly encountered traders who more closely resemble John the high-yield trader who is described in the first chapter, whereas Taleb's description of Nero Tulip (another more conservative person and trader) at times was uncannily similar to myself. (I just hope my ending is different!) Furthermore, the extent to which the book has been received and accepted gave me confidence that traders and investors are beginning to understand concepts such as stationarity and the misuse of probability, ideas that are central to my experience-based beliefs. Some of the concepts that I cover are probably more eloquently described in Taleb's book; I merely try to apply them to my topic of discussion.

Second, since moving to Western Australia, I have finally had the time to read many studies of technical analysis as well as of the relatively new field of behavioral finance. The former helped me to realize just what information and evidence on technical analysis are available. The latter is an exciting area that many private traders in particular will not be aware of. It is a positive science that bases its opinions on how people are actually observed to behave, whereas I believe that technical analysis and charting are more of a normative science and draw conclusions based on how they believe participants think. Until now, behavioral finance has been regarded as diminishing the case for efficient market theory; however, I hope to show that some of its findings also contradict some aspects of technical analysis. Perhaps of more relevance is that in those instances, it is possible to see and understand how and why markets behave differently from how technical analysts believe they behave. Behavioral finance can also offer us an insight into why technical analysis and charting are so popular.

Third, having attended seminars and read many advertisements from individuals and firms offering chart- or technical analysis–based trading courses to private traders, I was appalled by some of the tactics employed. I wanted to set the record straight and explain why many of the claims made by these firms are false or misleading. In fact, I am amazed at how different the trading and investing world is to those on the outside who view the markets through the media and their "educators." Some of what I have read in magazine articles or heard at seminars has been so far removed from what I and my bank trading colleagues discussed and used that I wondered whether we were in the same business.

Thus, I believe that it is private traders and investors who can learn most from this book. I have attempted to collate and explain many interesting studies and papers and views that such traders would otherwise not have seen. I also wanted to show that the claims of chartists and technical analysts are theory, not fact, and that they have yet to be adapted to new studies or changing markets. The first part of that sentence may seem obvious, but when I was researching technical courses, I found that many gave the impression of being scientific and based on proven credentials. I want to show that there is far more to a sustainable trading career than back-testing moving averages or being able to identify a rounded-bottom formation and that any individual who thinks that there are shortcuts to success is deluding him- or herself, no matter what some course providers suggest.

I outline many potential deficiencies in charting and technical analysis to try to create an element of doubt on the subject in readers' minds. Even if you do not agree with me on all points, I believe that there will be some that seem strong. Hopefully, through this book, readers will become aware that technical analysis is not as scientific as it is often made out to be and that there are many questions that need to be addressed. I realize that some criticisms are stronger than others, but my aim was to include as many different reasons as possible why technical analysis might be a flawed concept. There seems to be a belief that just because technical analysis has been around for X many years, it must be beneficial. I want to show that this is not necessarily the case.

I do not expect everyone to agree with my views, but I do think that the issue needs to be debated more thoroughly. I want this book to be a wake-up call both to the industry and to private traders who might be drawn into technical analysis without ever questioning its merits. People seem to accept all too readily claims such as "the head and shoulders is a reliable pattern."

During my career, I have never had a problem with challenging the accepted wisdom, and I believe that this has helped to improve my trading. For example, I was in a minority in London when I viewed short-selling options skeptically in the early to mid-1990s. I had particular trouble persuading two former Salomon Brothers proprietary traders who were at the bank where I worked of the validity of my views. But within just two or three years, after their former colleagues had suffered the collapse of Long Term Capital Management and a few other events, views such as mine became more accepted. As a very good trader told me early in my career, "Your most profitable trades will be when you have the opposite position to most in the market." His words were certainly wise ones, and they not only backed up my own instincts to challenge widely held assumptions, but also added to my belief that following the herd or the trend would not always be the right way to be positioned.

While many people feel more comfortable doing what others do, perhaps in our business we need to step outside the comfort zone and be prepared to make our own decisions, act on our own analysis, and see if we can make it. However, I am in no way suggesting that I have "cracked" this business or that I am anything more than a normal guy who likes challenging assumptions, questions almost everything he is told, enjoys a challenge, and tries to learn from his and others' mistakes.

I would also like to say that I fully respect many of the more honest technical analysts out there, even if I disagree with their opinions. I respect their belief in their field and their dedication to it, although I do not believe that their analysis can have as positive an impact on trading as they believe. To be fair to them, they spend many hours analyzing charts and data, and they realize that experience is important too and that there are no quick routes to success. However, it is the claims and teachings of the more unscrupulous that I believe could seriously damage the industry's reputation. They fill the public's head with false beliefs that a profitable trading career can be enjoyed simply through back testing easily available data or being able to recognize patterns. As I will highlight in the first chapter, even a supposedly respected senior member of the Australian Technical Analysts Association presented a seminar to potential clients for his course that I can only say highlighted some of the selling techniques that I object to so strongly. I realize that these firms and individuals are running businesses; however, unlike many industries, ours can actually lead to people losing significant sums of money. As someone who loves trading, I do not like to see individuals enter the business with false hopes, having been misinformed that there are easy routes to success.

While all the quotes and technical analysts' claims that I have used are genuine, I have not named individuals because I do not want to appear to be making personal attacks. I have used them simply because they are good examples of the points that I am trying to make. I have met some technical tutors who are thoroughly respectable, honest, and decent, but unfortunately, because of the nature of this book (a kind of reverse survivorship bias), they may not be mentioned. I expect a lot of criticism from those that I mention and from the technical analysis industry as a whole, but I am willing to accept this if it leads to a stronger debate on the topic.

At no point in my career have I ever made a conscious decision to doubt the benefits of technical analysis or charting; it's just that my experience of observing markets and their participants has led me to the conclusion that many of the assumptions of this form of analysis do not fit with what I have seen.

Of course charts will produce patterns, but I feel that the explanations for these patterns have little substance. In some cases the explanations for different patterns can contradict each other. In fact, when I was considering this point, I read the following statements in a course that was highly regarded in London. In the introduction, the author states, "It is fair to say that the vast majority of traders learn from their mistakes." Then, when discussing one of the main principles of technical analysis—namely, that history repeats itself, he comments, "Those who do not learn from the past are condemned to repeat the same mistakes over and over again. Sadly this is true of most people." I will discuss one area in particular where technical analysts believe that traders will learn from their mistakes or successes, which appears (to me) to contradict their belief that behavior is repeated. It seems to me that, having observed certain patterns appearing from time to time, technical analysts have tried to construct explanations for why they have developed. In effect, the answer is known, and the technical analysts have then looked for evidence that would allow them to reach that answer. Surely a better technique would be to find out why people make certain decisions, understand what factors drive the markets, and then see whether this fits with the observed patterns. If not, as I think is the case in many instances at least, the patterns should be explained by mere randomness. Fortunately, we can now test some of the theories of technical analysis with the results from the behavioral finance studies.

I have also made an effort to describe *why* I think certain beliefs of technical analysts are incorrect. My concerns have usually been aroused by what I have seen in the markets. I have then researched to see if these concerns were backed up by other studies. Thus, I have not just tried to compile a study of technical analysis and claim that it fails; rather, I have endeavored to explain where I have seen it fail and to offer explanations as to why this might be the case. By doing this, I sincerely hope that my criticisms of the field will be acknowledged as constructive. This is an approach that I use in all aspects of my life, particularly my trading. It is not enough for me to be right (or wrong) about something; if I do not know why I was right (or wrong), then the result is of little consequence and might be attributed to luck.

I would also like to say that I did not set out to find only studies that agreed with my opinions. If I had found that the overwhelming evidence available suggested there are substantial advantages to using technical analysis, then I would have been forced to admit that I was wrong and to change my view. I can assure readers that I have no problem admitting when I am wrong, especially regarding trading, as doing so can prevent losses. In fact, I actually made an effort to ignore overtly negative studies on technical analysis, preferring to analyze studies that could offer more of an insight into why it might or might not work. Some of these on the face of it were actually positive toward some technical methods, yet when these studies were analyzed in more detail, the conclusions were not so clear-cut. Furthermore, when quoting examples from technical analysts, I have used only respected analysts and institutions to avoid being accused of scouring the murkier side of the business in a quest to find misleading statements or erratic analysis.

I am neither a mathematician nor a scientist; I am just a simple trader. This is why I have tried to look at technical analysis from a trader's perspective. This is especially true of my analysis of the studies of technical analysis that have been conducted. There are people who are far more qualified than I to analyze the math behind them, although I do explore this area somewhat. However, with studies that use a sample period of say 100 years, I try to put myself in the position of a trader who was trading at the time to get a better idea of whether the trading tool was successful. As we shall see in Chapter 4, sometimes this can lead to different conclusions from those of the study itself.

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Finally, I would like to publicly thank my late grandfather, Jack Singer, whose teaching and wisdom have had such a huge influence on me.

INTRODUCTION

Trading and investing is a difficult business. There is much evidence to suggest that most individual traders and investors lose money during their (often short-lived) careers. Many people have grappled with the complexities of understanding economics and fundamental analysis and struggled to implement this and to achieve a successful trading technique. So when word spreads about people making money simply by analyzing past price data, whether it is done through patterns or indicators, it is easy to see why many will be attracted.

In fact, many of the principles of technical analysis and charting have been around for a hundred years or so, and there have always been a certain proportion of individuals who have believed in their merits. However I will describe in Chapter 1 how their popularity has increased in recent years and try to explain why.

Whereas investment banks put their trainee traders through a comprehensive training program before allowing them anywhere near a trading book, private individuals are being increasingly told that the answers to problems such as market psychology, when to enter and exit a trade, and how to test whether a strategy is successful can all be found through charts and/or technical indicators that are easily available.

Chapter 1 will also highlight some of the marketing ploys used by firms and individuals offering technical-based training courses and contrasts this to the methods of more fundamental-based course providers. I will also explain why some of the claims of the technical course providers can be misleading.

The second chapter outlines how and why technical analysis can sometimes yield positive results. Those who have read *Fooled by Randomness* will already be aware of concepts such as survivorship bias, data snooping, and the role that chance can have in all aspects of life, including trading. I also discuss whether technical analysis can be self-fulfilling (a hotly debated topic) and explain issues such as positive-feedback trading and how even "noise" traders (less-educated traders) can have profitable periods.

In Chapter 3, I discuss my own concerns with technical analysis as it stands today, the concerns that drove me to examine whether my beliefs (which were, after all, based on my trading experience) were supported by research that has been conducted on both technical analysis and trader psychology.

In the fourth chapter, I will outline and discuss the results of some studies of charting and technical analysis that have been conducted. Some of these are well-known within the industry but may be new to private traders. Importantly, in some cases I will look behind the headline conclusions of some of these studies to describe some of the secondary findings. These can be more important than the main conclusions. By the end of this chapter, readers should start to be building an awareness of just where the limitations of technical analysis might lie.

Chapter 5 introduces the field of behavioral finance, a relatively new field (compared to classical economics or charting), but one that is steadily gaining in popularity and acceptance. What is important to understand about behavioral finance is that it is a study of how individuals actually make decisions, including decisions where risk is a component, such as trading or investing. I will outline the main findings of this field and relate them back to charting and technical analysis in an effort to show that in some cases these findings are not compatible with the views of charting advocates. While behavioral finance is generally regarded as casting doubts on classical economics, and efficient market theory in particular, I hope to show that some of its conclusions are also incompatible with technical analysis as it is practiced today.

Chapter 6 analyzes the mechanics of modern markets and highlights just some of the different aspects that can affect a contract's price. What I aim to show is that just analyzing the price itself, without further knowledge or information, may not be enough. In fact, the idea of context is a central theme throughout the book. Just looking at a price or a series of data is, I believe, of little use without knowing the context of the information.

In Part 2 of the book, I outline a few suggestions to help us make better decisions. The starting point for this process is understanding the basics and fundamentals of our markets and doing our due diligence before we trade; this is all described in Chapter 7.

In Chapter 8 I discuss my belief that rather than being ahead, markets price in outcomes that may or may not be valid, as they can sometimes reflect irrational thinking. I explain how understanding context and weighing possible outcomes are important techniques for us to learn and master.

Chapter 9 again covers the question of whether markets are ahead. We look at two correlated markets that are pricing in completely different outcomes. I suggest that they can't both be ahead.

In Chapter 10 I explain why it is important for us to make proactive decisions and how many technical indicators are too reactive for my liking.

And finally, in Chapter 11 we revisit the topic of behavioral finance and examine ways of avoiding or overcoming the heuristics.

Throughout the book, I have tried where possible to include anecdotes from my own experience as a way of describing how some of the points I make affect us in reality. I thought it very important that every issue that I deal with can be easily and directly related back both to the subject and to trading in general.

I would also like to emphasize that I am in no way strictly a believer in fundamental analysis. I believe that the widely held view that there are only two forms of analysis, fundamental and technical, is a little misleading. Understanding market fundamentals is important and can provide a reference point. Some forms of technical analysis can sometimes help, too, but on their own, both forms can have many drawbacks. Some traders use the two means together, which may be an improvement; however, there are still some missing links. As I will show that technical-based analysis of market psychology is flawed, this is one area in particular that traders will need to learn more about. Concepts such as weighing what is being priced into a contract and how this will be affected by possible outcomes, which is all part of the wider area of understanding risk, are just some of the complex areas that successful traders have to grapple with. Experience and art are a couple of extra factors that we will need to help us through this process. The former is possible only if we have a more rounded understanding of the markets (as well as discipline, humility, and some luck); the latter is something that not everyone will have and that will separate those who are cut out for a career in this business from those who are not. Unlike some of the advertisements that I see, I do not believe that everyone has the necessary attributes to be a successful trader or investor. For those who don't, it is important that they realize this early, before they lose too much money.

CONTENTS

PART ONE

The Reality of Technical Analysis