Wiley Trading Series

TECHNICAL ANALYSIS AND CHART INTERPRETATIONS

A COMPREHENSIVE GUIDE TO UNDERSTANDING ESTABLISHED TRADING TACTICS FOR ULTIMATE PROFIT

ED PONSI

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Technical Analysis and Chart Interpretations

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INTRODUCTION: THE JOURNEY

Every trader must follow their own path. Maybe technical analysis will be part of your path, but even if your journey takes you in another direction, it's still important to understand the concepts in this book. As you read on, the reasons why will become clear.

How did technical analysis become a part of my journey? It started with my first job interview in the financial services field, which was for a position as a stockbroker.

I was led by two senior brokers into a tiny, glass-encased room. Two more brokers were already waiting there. They began asking questions—slowly at first, then more rapidly. They bombarded me with questions to see if I could handle the pressure. My heart raced: Was I up to the challenge?

"Name your five favorite stocks," they asked.

"Ascend Communications, 3Com, Cascade, Cisco Systems," I replied.

At the time, all four companies were in the rapidly expanding computer networking sector. That sector was on fire, making headlines on a daily basis with its huge gains and wild swings.

"That's four ... keep going ... "

"Four ... Fore ... "

"Ford? Ford Motor Company?"

"No, Fore Systems."

I'd named another computer networking stock. I was five minutes into my first interview, and I'd already broken every rule of diversification. Had I blown my opportunity to break into finance?

Surprisingly, my interview caught the attention of a senior broker who specialized in technical analysis. He knew that all the stocks I'd named were in the strongly trending computer networking sector. I was hired at his recommendation and

became a member of his team, which placed a heavy emphasis on technology and momentum stocks.

Our reading assignments included books such as *The Gorilla Game: Picking Winners in High Technology* by Geoffrey Moore. We were also instructed to read a number of books on technical analysis, including *Secrets for Profiting in Bull and Bear Markets* by Stan Weinstein as well as titles by John Murphy and the team of Edwards and Magee.

On our team, technical analysis was the key to every decision. While others paid close attention to fundamental research reports, our team cared only about price action. Every company's chart was to be thoroughly analyzed. I dove into the reading materials with gusto.

Total Immersion

What happened next could only be described as total immersion. We were like cult members. Our team of four would work from 8 a.m. until the closing bell. After the close, we'd look at every single chart in the S&P 500.

Then we'd go to dinner, or to the bar, or just hang around the office while the cleaning crew worked around us, and the technical analysis conversation would continue. Any remaining time was spent reading additional books on technical analysis and growth stocks as assigned by our mentor.

While I loved learning about technical analysis, I wasn't fond of being a broker. At one time I'd believed that brokers traded and managed money for their clients. This is only somewhat true; eventually, I learned that being a broker has more to do with selling than with trading.

The final straw occurred when my employer asked me to obtain a license to sell life insurance. There is nothing wrong with selling insurance to people who need it; I just didn't want to be the person who sold it to them. Instead, I wanted to use everything I'd learned about technical analysis to become a full-time professional trader. So, I quit.

The Next Step

For a long time, I'd been sending my trading track record to anyone I could find who hired traders. I'd scour the Sunday *New York Times* and collect e-mail addresses, and then bombard them with my trading record. I had a solid record, mainly thanks to the very forgiving bull market environment of the 1990s.

After months of this, with no indication that anyone noticed or cared, the phone finally rang—would I like to interview for a trading job on Wall Street?

This time, I was interviewed by just one person—and he seemed like a maniac. He stomped around his spacious Wall Street office, alternately mumbling and shouting.

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His expensive suit was wrinkled and uneven, and he needed a shave. He looked as if he'd been out all night.

Suddenly, I wanted my old job back, a good paying job from which I'd walked away. What had I gotten myself into?

I didn't know it at the time, but this man was a well-known character on Wall Street. He ran several investment firms, one of which employed over 400 traders. When I told him I was willing to travel 100 miles by train to get to work every morning and another 100 miles to get home every night, he hired me on the spot.

Once again, it was a case of total immersion. I'd catch a train before dawn, always clutching a book and a copy of *Investor's Business Daily*. Eventually, one of those books would be *Confessions of a Street Addict* by legendary hedge fund manager Jim Cramer. Years later, I'd work with Jim and even merit a brief mention in one of his books.

I saw the same faces every morning on the train. Every day, a young man and an older man would board the train together, and I'd overhear them discussing technical analysis. The older gent was an experienced arbitrage trader, and the kid was a college athlete who was just getting started in the business. Every day, we'd discuss indicators and other technical concepts. Years later, we would all work together at a midtown Manhattan trading firm.

Hiding from the Boss

My first trading job could only be described as Darwinian—it was the survival of the fittest. The firm's philosophy of cutting losses quickly apparently translated to the company's attitude toward its traders. Nearly every day, another desk would be vacant, its former occupant never to return.

The company had a lengthy set of rules, particularly regarding risk management. I had trouble making money at first, as I struggled to adjust my somewhat wild trading style to fit within the company's parameters. Every day brought with it a new defeat followed by the long train ride home.

Meanwhile, the new hires I'd started with were disappearing one by one. Why had I left my secure job and gotten involved in this mess? I lost money, lost sleep, and lost my appetite. I thought I'd lose my mind.

I really thought I'd be fired, but I kept showing up. In the hallways at work, I avoided at all costs the man who hired me. I figured he'd simply forgotten to fire me, and I didn't want to jog his memory.

A few months later, after I'd gotten my act together and become profitable, I finally gathered enough nerve to march into the wild man's office. I needed to ask why he hadn't fired me while he was letting the other new hires go.

What he said startled me: "We didn't fire you because *we like the way you lose.*"

He explained that while losing, I'd demonstrated "good defense." I wasn't profitable, but I hadn't lost much money, preferring to take a quick loss rather than a

"hang on and hope for the best" approach. This meant that having me around wasn't a big expense to the company. My boss reasoned that since I'd already learned the proper way to lose, he might as well let me stick around for a while to see if I could learn how to win.

It All Comes Back to Technical Analysis

Of course, the entire "good defense" concept was a result of my immersion in technical analysis. All of those hours spent looking at charts had created an internal mechanism that kept me out of trouble. How could I hold on to a stock if I knew its chart was breaking down? The charts had helped me to act objectively on what was actually happening in the market.

Technical analysis had taken the emotion out of my trading. It helped me to avoid being drawn into a subjective narrative. The reality of the price trumped the inner voice that whispers, "It's a good stock, don't sell it yet, it'll come back." Once I understood that reality, it was impossible to ignore.

The game of trading is constantly changing. The recent advent of high-frequency trading has closed certain loopholes that a clever individual trader could use to his or her advantage. However, as one door closes, another one opens. There are always ways to win at this game, and if you want to win badly enough, you will find them.

This book is designed to give you an advantage. If you can read a chart, you'll know when to get into a trade; even more important, you'll know when it's time to get out. Charts provide a visual history of the price and reveal the strengths and weaknesses of the market participants. Understanding those strengths and weaknesses helps us to anticipate future turning points.

Maybe the best thing about technical analysis is this: It forces us to confront the realities of the market. Technical analysis allows us to deal with what is *actually* happening instead of what we believe *should* be happening. Belief can be a dangerous thing in trading—specifically, the belief that we know what should or will happen in any given situation. It's better to see things as they really are than as we wish to see them, and technical analysis allows us to do just that.

ABOUT THE AUTHOR

Ed Ponsi is the managing director of Barchetta Capital Management LLC. An experienced professional trader and money manager, Mr. Ponsi has advised hedge funds, institutional traders, and individuals of all levels of skill and experience. He has made hundreds of appearances on national and international networks such as CNN, CNBC, the BBC, and Bloomberg. A dynamic public speaker, Mr. Ponsi has lectured audiences around the world, in locations such as London, Singapore, and New York City.

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PART I

The Foundation of Technical Analysis

Why Technical Analysis?

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

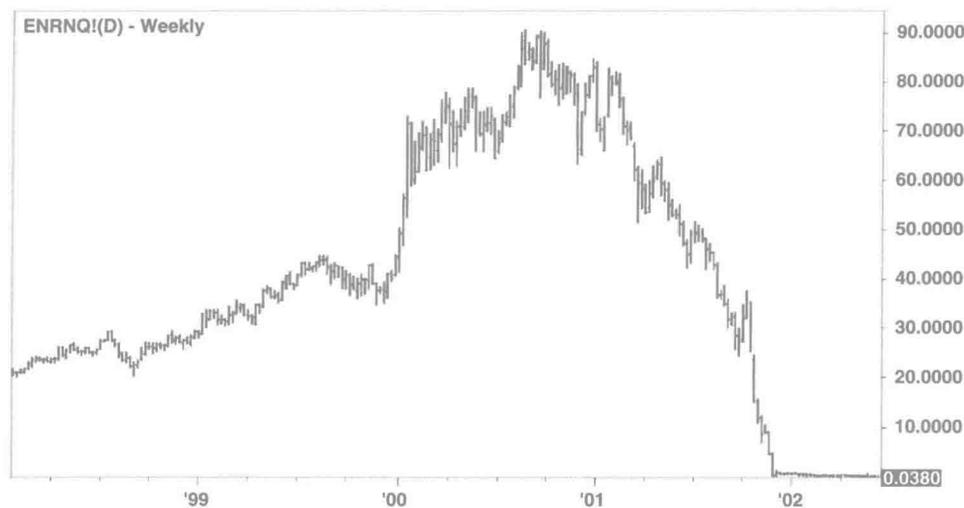

FIGURE 1.1 The Rise and Fall of Enron

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.

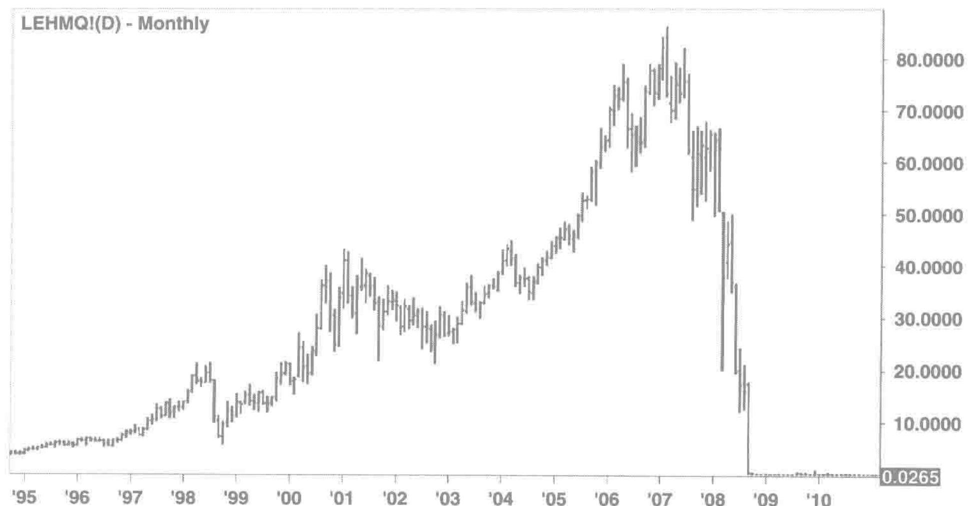

FIGURE 1.2 The Rise and Fall of Lehman Brothers

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