Market Dynamics

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Performance Management System

Fundamentals Versus Charting—Mutually Exclusive? Part 1

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

"Don't gamble; take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it."

Will Rogers (1879 - 1935)

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Market Dynamics
7325 S. Jackson St.
Centennial, Colorado
80122

Phone: 303-804-0507

clayallen@msn.com

Most long-term investors believe that not only is fundamental analysis superior to technical analysis but that long-term investors must have nothing to do with stock charts, whatsoever! This idea is often aggressively indoctrinated in undergraduate finance course work by professors who base their case on the randomness of stock price movements. But can long-term investors benefit from the use of charts?

The debate about the usefulness of stock charting can be traced back to at least to the time of World War I in the writings of Richard Wyckoff. The evolution of the theory of investment management over the ensuing years seemed to resolve the question "once-and-for-all" by the academic use of advanced statistical methods that found the fluctuations of the stock market to be random in nature and therefore unpredictable. So why does technical analysis persist in the face of such damning evidence? Are investors kidding themselves that there is value in stock charting or is there something else at work?

First of all, technical analysis evolved as a tool for short-term speculation, not long-term investing. It was an attempt to profit by short-term movements in the stock prices.

However a school of technical analysis developed around the time of WW I called point and figure charting. This charting technique was made popular among long-term individual investors and its charts could be maintained from a good daily newspaper. Probably without knowing it, Point and Figure charting applied a filter to the stock price data that greatly diminished the influence of meaningless, random stock price movements and let the major trend show through.

The Crash of '29 and the Great Depression not only wiped out the individual speculator, it made stock charting a four-letter word and the potential of long-term investing was realized in the post WW II period. During this time, cash dividends were often higher than bond yields and yet risk aversion was still very high. The virtues of long-term investing were proven by the price appreciation experienced during the post WW II bull market.

The long-term investor did not need stock charts because stocks just went up. "Buy and hold" was the investor's holy creed and the academic revelations of randomness demonstrated that stock charting could not predict future stock prices. Subsequent market movements frustrated long–term investors because the tailwind of the bull market degenerated into a trading range market that was followed by a gigantic stock market bubble.

Experience derived during the aftermath of the numerous bubbles in stock prices from 1980 onward defined the need for long–term chart analysis as a tool for selling stocks and avoiding being trapped in the bearish moves that invariably followed the up trends of stock market bubbles. Technical analysis evolved as a tool for long-term investors. During the past forty years the point and Figure method of stock charting has proven its merits as a tool for the "sell decision," to help long-term investors protect capital- not speculate.

More to follow next week

W. Clay Allen CFA