# Technical Analysis: What is it and Why Use it?

Most people start off accepting the basic premise of what is called *fundamental analysis*, that a financial security (share, option, warrant, futures contract) has what is called an *intrinsic value*. However, a little experience in the markets soon shows that this intrinsic value is difficult to determine and that expert analysts are often in disagreement about it. The reason is that such valuation is very subjective. Anyone with any experience with takeovers will know about *independent expert* valuations that vary wildly.

A more important problem is that the market often prices financial securities at prices at variance with commonly agreed value. While it can be shown that there is a long-term correlation between value and market price, in the short term (months or years), market prices differ substantially from value. So, while one can profit by buying securities that the market is undervaluing and holding them until the market adjusts, our capital could be better employed elsewhere in the interim. In other words, there is a timing problem.

Instead of trying to determine the underlying value of a security, *technical analysis* seeks to identify when the market actually begins to identify mispricing in the market. Once this happens, price tends to rectify the situation. However, this does not happen overnight and instead takes place gradually, forming a trend on a chart of market price. What the technical trader tries to do is enter once the adjustment process is under way and exit once it has finished.

There are two common misconceptions about technical analysis. The first is that technical analysts try to forecast the future. Indeed, some analysts do try to do that. However, they are no more successful than economists in general and those employed by governments in particular. However, those who trade successfully using technical analysis do not try to forecast prices. Instead, they restrict their endeavours to identifying trends. This is much easier to do and is a much more profitable approach to the markets.

The second common misconception is that it is necessary to identify the top and bottom prices in the trend. Again, there are some technical analysts who try to do this, with conspicuous lack of consistent success. Those technical traders who are consistently successful in the markets enter the trend once it has clearly started and exit once it has clearly ended.

How does the technical analyst do this? It is done by studying the market for the financial security itself. This primarily means studying price, but includes the volume of trading. In some derivatives markets (principally futures and options), the open interest, or number of contracts open at any time, is also used.

This is because the technical analyst understands that there is a difference between the value of a company if you purchased all of it in a takeover and the value of its shares. The value of the shares is driven not only by the underlying value of the company, but also by the needs and expectations of shareholders and potential shareholders. Two simple examples are the person who must raise cash in a hurry, who will accept a lower price because of time constraints and the fund manager caught without a holding of a stock that starts to move who will pay a higher price because he cannot afford to let his competitors do better in the fund performance ratings.

 

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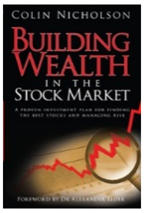


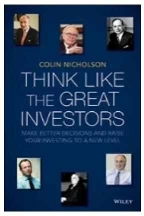


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