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Essential Guide to

Picking the Direction of Shares

A guide to fundamental analysis.

BOOK 2

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Contents

Important Information
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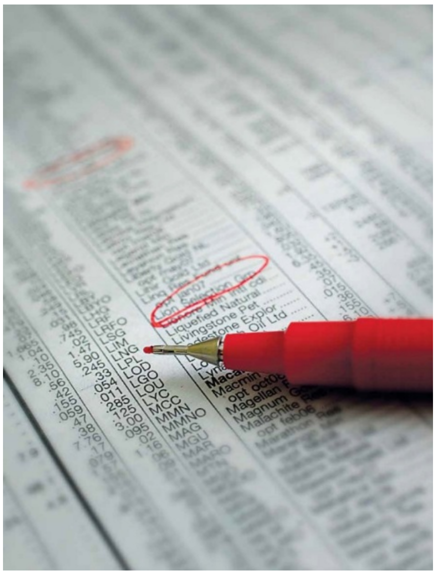
TECHNICAL ANALYSIS BASICS

As mentioned earlier, technical analysis relies not on company details, but on share price charts, and the formations and patterns they make. Chartists interpret these historic movements looking for guidance to the future direction of the share price. The rationale is that a chart illustrates the psychology of the market, which is essentially a tug of war between fear and greed. Know what you are looking for, they say, and the charts will tell you when to buy and sell.

The tools of a chartist's trade are data and software packages. Some basic charting tools are freely available on the internet while investors wanting to focus on technical analysis in a more serious way can buy more detailed analysis packages offered by commercial providers.

Charting is a complicated subject. In this guide we will touch on a few basic concepts, including trend lines, support and resistance lines, and the formation of ascending and descending triangles.

But first we need to take a closer look at the various types of charts.



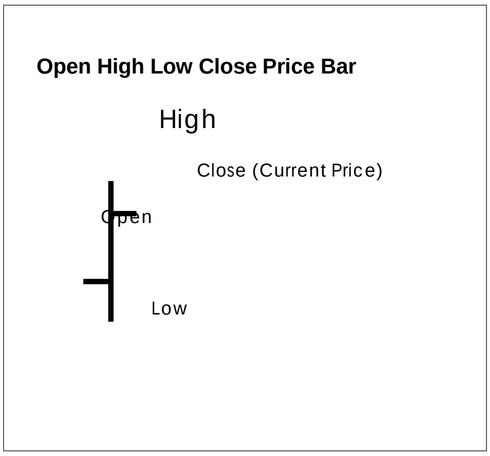
TYPES OF CHARTS

Chartists use several different chart types. Three of the more popular are the OHLC chart, candlestick chart and basic line chart.

OHLC CHART

OHLC stands for the open, high, low and close price – which are represented on each bar of the chart (see inset, below). Quite simply, each bar shows the open and close prices and the share price range in any given period.

If the share price closes on or near the low, it is considered that sellers are in control, and if it closes near the high, it is considered that buyers are in control. An example of a chart formed by daily bars is below.



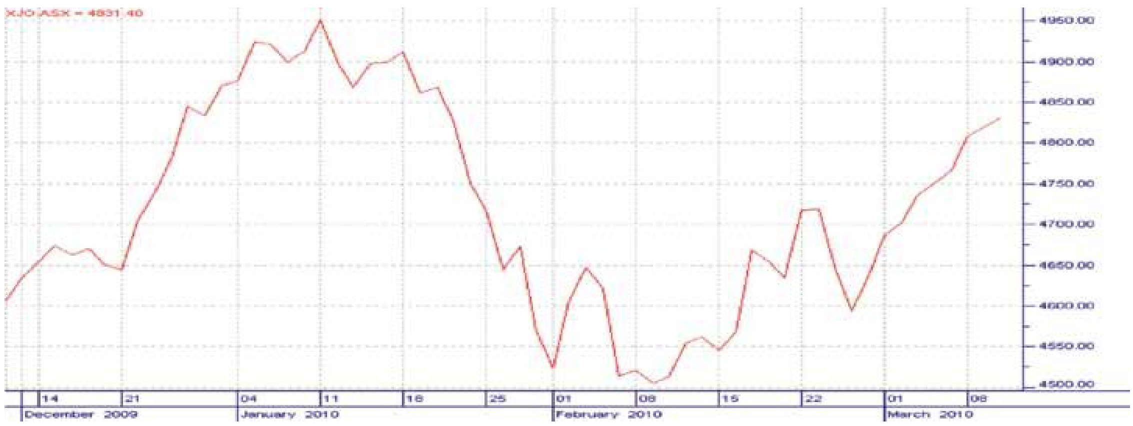
CANDLESTICK CHART

Candlestick charts are thought to have been first used by Japanese rice traders around the 16th century to identify price trends. Today, proponents of this chart type think it can more accurately pinpoint whether buyers or sellers are in control of a stock. In the candlestick chart below, a green candle represents that buyers are in control that is that the share price closed near its high, while a red candle indicates that sellers are in control, or that the share price closed near its low. Like OHLC charts, candles also depict open, high, low and close prices but some traders prefer them because they usually come with enhanced graphics.

LINE CHART

In contrast, line charts show just closing prices and quite simply join the dots (see below). As such, they offer the least information but are easiest to read. They can be useful when examined in conjunction with the other chart types.

So just what can these various charts tell you about the future direction of a stock price?



'THE TREND IS YOUR FRIEND'

Prevailing sentiment gives a valuable clue as to what might happen next. The trend – as they say – is your friend. Chartists consider that the share price is likely to continue in the direction of a trend line. It is far safer to buy a share when it has rebounded 5 per cent than to try and pick a stock's very bottom.

If share price troughs and peaks are both rising over time, there is obviously an uptrend. But chartists prefer to see three consecutive higher troughs and three consecutive higher peaks before acting. They draw the trend line for an uptrend so it intersects the rising troughs (see below).

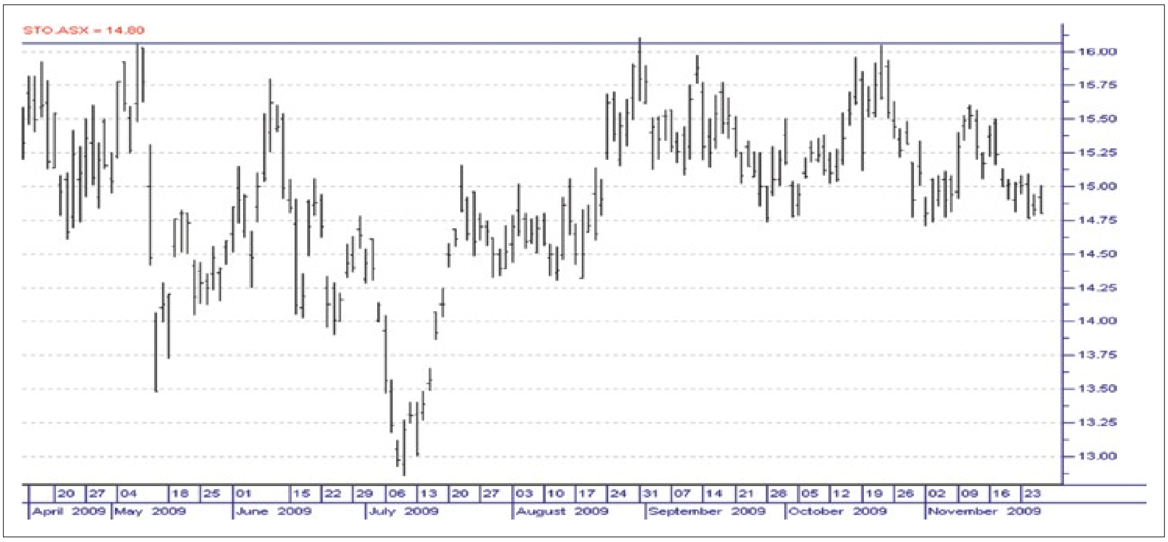
And they draw the trend line for a down trend so it intersects the falling peaks (see below).

SUPPORT AND RESISTANCE LINES

Beyond the simple trend indicators, technical traders consider the concepts of support and resistance key.

A support line shows the lowest price at which investors will allow a stock to trade. In other words, the price is unlikely to fall below this level. The example below shows a stock with support at around $25.20. Chartists believe that if support is broken, the share price is likely to fall to the next level of support.

The resistance line is the opposite of a support line. It shows the highest price at which investors will allow a stock to trade. In other words, the price is unlikely to rise above this level. Below you can see a stock that is hitting a resistance ceiling at $16.06. Every time it touches this level it is sold down and the chart falls away. Just as with a support line, if resistance is broken the share price will probably rise to the next level of resistance.



COMMON PATTERNS

Charts can be used to draw not just lines but also patterns that can shed light on when to buy and sell. We will next examine a couple of the most common patterns.

THE PENNANT

A pennant is seen particularly with stocks that are trending in one direction. It occurs where a rising line of support meets a falling line of resistance. The theory is that a pennant pattern is usually followed by some type of share price breakout as pent up momentum is released, much like releasing a coiled spring. In the first chart below, you can see a stock moving into the apex of the triangle – and in the second, the share price breakout. As such, technical traders consider a pennant a powerful signal to buy.

THE ASCENDING TRIANGLE

An ascending triangle is formed when an uptrend approaches a level of resistance. As with a pennant, the share price range tends to become compressed as it moves towards the triangle's apex, and so builds momentum. On the price breakout, you typically also see the same explosive move (see the charts below). Chartists argue that an ascending triangle is a more reliable signal of a price surge than a pennant as the stock is already trending up.

THE DESCENDING TRIANGLE

Here is how the opposite pattern, a descending triangle, looks. This is believed to precede a major downturn.

So there you have it: a brief look at technical analysis and how its proponents use charts to determine investor sentiment towards a stock and, therefore, divine the future direction of its share price.

Keep in mind, though, that technical analysis is a complex subject and it is important to do further reading and research to fully familiarise yourself with the tools and techniques for successful share trading.

The big question, however, is whether fundamental or technical analysis will produce the best Sharemarket returns.

WHAT'S THE BEST APPROACH?

The best approach for you – fundamental or technical analysis – will vary depending on whether you are an investor or a trader.

An investor is someone who holds shares for the longer term, whether that be primarily to realise profits down the track or to receive dividends in the interim – or both. Most superannuants and people with DIY super funds fall into this category, as investing carries a lower risk than trading.

With their lower risk profile and longer time horizon, investors are likely to place more emphasis on fundamental rather than technical analysis.

Traders, by contrast, buy and sell shares more frequently in the hope of making a quicker buck. Dividends are usually of little interest (unless the strategy is specifically geared towards this) and shares can be held anywhere from minutes to a year or more. This short term strategy involves a heightened potential to lose money.

Accordingly, to engage in share trading, you need to be willing to take on higher risk. Your share price entry and exit points will also be far more important than someone who is willing to ride out peaks and troughs over the longer term. So traders typically rely more heavily on technical analysis. Indeed, there are some who completely disregard a company's other characteristics and look only to the charts to tell them what action to take.

Again, the best approach will depend on you and your investment strategy. In the interests of prudence, however, you might consider a bit of both – fundamental analysis to identify potential investments and technical analysis to indicate when to buy and sell.

A FINAL WORD ON PORTFOLIO CONSTRUCTION

Regardless of whether you favour a particular analysis technique, or indeed a combination of both, be sure to conduct robust research. Good sources of information include The Australian Financial Review, the ASX website, and some stockbroker research.

It is also vital that you consider how best to mitigate risk. One of the best ways is through diversification – spreading your money across several holdings so that a downturn in one will not decimate your wealth. The optimal number of stocks is a matter for debate, but generally 12 to 15 is considered appropriate where the total portfolio is worth $100,000 or more. Any fewer could leave you vulnerable to losses, while any more will see transaction costs eat into your returns.

You also need to think carefully about the mix of the shares you choose. It is not enough just to include a diversity of companies in your portfolio, you also need to hold shares in a diversity of industries, spreading your investments across a decent number of the different sectors represented on the Australian Sharemarket. It is also worth considering diversifying geographically – with a spread of international and Australian shares – so that a downturn just in our own market will not drag down your entire portfolio.

Finally, be sure to review your portfolio regularly. This is important, both to identify shares that may no longer be appropriate to hold, and to keep track of those that may have grown to represent too large a proportion of your holdings. Regular portfolio rebalancing – selling down such shares in favour of others to maintain diversity – is crucial to a safe, successful portfolio.