

SECTION ONE

Introduction

Traders and investors have been using a visual approach to investing for over a century. Up until the past decade, the use of visual analysis as a serious method of trading and investing was pretty much limited to professionals and full-time traders. Most successful traders would never think of making a trade without first consulting the pictures on their charts. Even the Federal Reserve Board now uses price charts.

WHAT HAS CHANGED?

For the average investor, however, the world of visual trading had been largely closed. The intimidating jargon and complicated formulas were beyond the reach and, indeed, the interest of the nonprofessional investor. A couple of important factors have changed that in the past decade. The most important is the availability of inexpensive *computers* and Internet charting services. The investing public now has an impressive array of technological and visual tools that weren't available to the professional community 30 years ago.

The second development has been the dramatic expansion of the *mutual fund* industry to the point where more mutual funds exist than stocks now traded on the New York Stock Exchange. This phenomenal growth has produced both benefits and challenges for the average investor. The challenge lies in the fact that the job of choosing among mutual funds has been greatly complicated. In a very real sense, the mutual fund growth has

made the task of the individual investor more difficult. The original purpose of mutual funds was to *simplify* investing. If someone didn't have the time or expertise to pick stocks, that task could be turned over to a mutual fund manager. Besides professional management, instant diversification was provided. An investor could buy one fund and be in the market. Now, however, mutual funds are so segmented that the investor has a bewildering set of choices to make. In the past decade, the arrival of *exchange-traded funds* (ETFs) has replaced many mutual fund choices.

FUND CATEGORIES

Domestic stock funds are categorized by goal and style—*aggressive growth*, *growth*, *growth and income*, and *equity income*. Funds are also divided by the size or capitalization of the stocks included in their portfolios. *Large-cap stock funds* limit their portfolios to those stocks included in the Standard & Poor's 500 stock index. *Midsized funds* focus on stocks included in the S&P 400 Mid-Cap Index or the Wilshire Mid-Cap 750. *Small-cap funds* choose their portfolios from the Russell 2000 or the S&P 600 Small-Cap Index. Stock funds can be further identified by their specialization in various stock market sectors, such as *Technology*, *Basic Industry*, *Health Care*, *Financial Services*, *Energy*, *Precious Metals*, and *Utilities*. Stock sectors can be further subdivided into *industries* with even more specified funds. The Technology sector, for example, would include funds that emphasize *computers*, *defense and aerospace*, *communications*, *electronics*, *software*, *semiconductors*, and *telecommunications*. Fidelity Investments offers as many as 40 sector funds for the individual to choose from.

GLOBAL FUNDS

Another dimension has been the growing popularity of global investing. Investors can now trade in individual foreign countries or geographic regions by selecting the appropriate stock fund. As a result, investors are forced to keep abreast of market developments not just in the United States, but all over the world. While overseas investing carries more risk than domestic funds, the rewards are well worth it. From 2003 through the end of 2007, foreign stocks rose more than twice as much as U.S. stocks.

During these same four years, emerging markets gained four times as much as the U.S. market. Overseas investing provides diversification from the U.S. market, which is why financial advisors recommend leaving as much as a third of one's portfolio abroad to improve returns and lessen risk.

INVESTORS NEED TO BE BETTER INFORMED

For many investors, *fund* investing has replaced *individual stock* selection. However, with the degree of segmentation that has taken place in the stock fund industry, investors have little choice but to become better informed and more actively involved in the fund selection process. Investors must be aware of what different sectors of the American market are doing as well as how global markets are faring. The number of choices available to the investor is a mixed blessing.

So, too, are the technological advances of the past decade. The problem is knowing how to select and use the resources available. The technology has outpaced the public's ability to use the new data in the most efficient way. Which brings us to the purpose of this book—to help the average investor quickly acclimate to visual trading; and then show how these relatively simple principles can be applied to the problem of sector investing primarily through exchange-traded funds.

BENEFITS OF VISUAL INVESTING

The bright side of the increased specialization among funds is that the investor has never before been provided with so many vehicles to choose from. Individuals who favor a certain market sector or industry, but don't want to choose which stocks to buy, can now buy the whole group. Sector funds also provide additional ways to diversify one's core stock holdings and to pursue more aggressive growth opportunities with a portion of one's assets. That's where visual analysis comes in.

The tools explained in this text can be applied to any market or fund anywhere in the world. With the aid of a computer and easy access to price data, the task of monitoring and analyzing funds has been made immeasurably easier. The power of the PC can also be harnessed for such things as *monitoring* portfolios, *back-testing* rules for buying and selling decisions, *scanning* charts for attractive opportunities, and *ranking* funds by relative performance. While the challenges of learning how to apply new technology to fund and sector investing are there, so are the rewards. If you're in the market, you've already accepted the challenge. This book will show you how to reap the rewards.

STRUCTURE OF THE BOOK

The book is divided into four sections. Section One explains what visual analysis is and how it can be blended with more traditional forms of

investment analysis. The critically important subject of *market trend* is explained, along with some visual tools to help identify the trend. You may be surprised to discover how much value lies in some of the simplest tools that are covered in the first section. Throughout the book, a special emphasis is placed on ETFs. Exchange-traded funds have greatly simplified the asset allocation and sector rotation process.

Section Two covers some of the more popular market indicators in use today. We stress the *concepts* behind the various indicators and how they are *interpreted*. We limit our coverage to only the most useful tools. For those wishing to explore the world of indicators more fully, reference sources are given at the end of the book.

Section Three introduces the idea of *market linkages*. This is especially important in order to appreciate why stock market investors should also monitor movements in commodity prices, bond prices, and the dollar. *Intermarket analysis* is also helpful in understanding asset allocation and the process of sector rotation within the stock market. Along the way, you'll gain some insight into policy-making decisions of the Federal Reserve. You'll be able to watch many of the same things the Fed watches.

Section Four focuses on sector analysis. *Relative strength* analysis is shown to play an important role in the selection process. We also show you how to analyze the global markets.

I'll pull things together in the Conclusion with the admonition to keep things simple, along with some final thoughts. The Appendices will offer advice on getting started and where to find valuable resources to help you do so. The Appendices will also introduce some increasingly popular charting styles you might want to incorporate into your visual analysis.

CHAPTER 1

What Is Visual Investing?

They say a picture is worth a thousand words. Maybe they should have said a thousand dollars. After all, we're talking here about using pictures to make money. And that's really what this book is about. It's that simple. A stock either goes up or down. If it goes up, and you own it, that's good. If it goes down, and you own it, that's bad. You can talk all you want about what a stock *should* be doing or *why* it isn't doing what it *should* be doing. You can talk about inflation, interest rates, earnings, and investor expectations. Ultimately, however, it comes down to the picture. Is the stock going up or down? Knowing the reasons behind a stock's movement is interesting, but not critical. If your stock goes up on a given day, they won't take the money away from you if you don't know why it went up. And if you can explain why it went down, they won't give you back your lost money. All that really matters is a picture, a simple line on a chart. The trick to visual investing is learning to tell the difference between what is going up and what is going down. The goal of this book is to help you tell that difference.

WHY MARKET ANALYSIS?

As the various chapters unfold, you will be provided with some relatively simple visual tools to aid you in market analysis and timing. Notice our use of the term *market analysis*. Whatever you choose to call it, the bulk of this book deals with visual analysis of the financial markets by utilizing

price and volume charts. Analysis of fundamental data, such as earnings expectations and the state of the economy, helps determine what a stock *should* be doing. Market analysis tells us what the stock actually *is* doing. The two approaches are very different. The use of earnings estimates comes under the general heading of *fundamental* analysis. The use of market analysis comes under the heading of *chart*, or *visual*, analysis. Most investors are more familiar with the fundamental approach because that is what they are taught in school and read about in the media. There's no question that the fundamentals are what ultimately move a stock or group of stocks. It's just a question of how one goes about studying those fundamentals and their effect on the stock.

THE TREND IS TO BLEND

The fact of the matter is that most successful traders and money managers use some blend of the visual and the financial. The more recent trend is toward a blending of the chart and fundamental disciplines. The use of *intermarket analysis*, the study of *market linkages* (discussed in Section Three), blurs the line between those two disciplines even further. The intention here is simply to explain how the two approaches differ and increase the reader's understanding of why the charting (or visual) approach should be a part of any investment or trading decision.

WHAT'S IN A NAME?

Visual analysis (also called *chart* or *technical analysis*) refers to the study of the market itself. Price charts can show individual stocks, industry groups, major stock averages, international markets, bond prices, commodity prices, and currencies. Visual analysis of various types of funds can also be accomplished. Many people are intimidated by the term *technical analysis*. As a result, they deprive themselves of the benefits of a very useful form of analysis. If that is the case with you, simply call it *visual analysis* because that's what it is. The dictionary defines *visual* as "capable of being seen by the eye; visible." *Technical* is defined as "abstract or theoretical." Believe me, there's nothing abstract or theoretical about this form of analysis. I'm often amazed at the number of people who are terrified by technical analysis but look at price charts all the time. They're scared more by the name than the analysis. To relieve that anxiety, we'll use the terms *visual analysis*, *market analysis*, and *chart analysis* throughout this book.

WHY STUDY THE MARKET?

Let's suppose an investor has some money to invest in the stock market. The first decision is whether or not this is a good time to put new funds into the market. If it is, which sector of the market would be most suitable? An investor has to study the market in order to make an informed decision. The question is how to accomplish that task.

An investor can read the newspapers, plow through a lot of earnings reports, call up his or her broker on the phone, or subscribe to some financial publication or web site. All of those things should probably be done as part of the process anyway. But there's a quicker and easier way: Instead of wondering what the market should be doing, why not look at what it is doing? Begin by studying the price trend of major stock averages. Then, look at the charts of the various stock sectors to see which way they're trending. Both steps can be accomplished in a matter of minutes by looking at the appropriate chart pictures.

CHARTISTS ARE CHEATERS

In a way, using chart analysis is a form of cheating. After all, why does a stock go up or down? It goes up because its fundamentals are bullish. It goes down because its fundamentals are bearish. Or, at least, that is how the market perceives a stock's fundamentals. How many times have you seen a stock fall in price in the face of a bullish piece of news? What matters isn't always the actual news, but what the market was expecting and what it thinks of that news.

Why, then, is chart analysis cheating? Because it is a shortcut form of fundamental analysis. It enables a chartist to analyze a stock or industry group without doing all of the work of the fundamental analyst. And how does it do that? Simply by telling the chartist whether the fundamentals of a stock are bullish or bearish by the direction its price is moving. If the market perceives the fundamentals as bullish, the stock will be rewarded with a higher price. A negative market evaluation of a stock's inherent fundamental value will punish the stock by pushing its price lower. All the chartist has to do is study the direction of the stock to see if it is going up or down. It almost seems like cheating, but it really isn't. It's just smart.

IT'S ALWAYS JUST SUPPLY AND DEMAND

The simplest way to understand the difference between the two approaches is to consider *supply and demand*. Simple economics tells us

that when demand increases relative to supply, prices rise. When supply exceeds demand, prices fall. The same principle applies to stocks, bonds, currencies, and commodities. However, how does one tell what those supply and demand figures are? The ability to tell which is greater is obviously the key to price forecasting. The hard way is to actually study all of the supply and demand factors, individually and collectively, to determine which is greater. The easier way is to let the price itself tell us. If the price is rising, demand is greater. If the price is falling, supply is probably greater.

CHARTS ARE JUST FASTER

An excellent example of the difference between the two approaches was provided to me early in my career as a market analyst. Our portfolio manager called me and a fundamental analyst into his office one day and gave us both the same assignment: to analyze the historic value levels for a list of stocks that he was considering purchasing for the company's investment portfolio. He wanted to know at what level each stock was overvalued and which were at more reasonable historic levels and more suitable for purchase.

I went back to my office and got out a long-term chart book showing price histories, going back several decades, for each stock. I simply noted the price levels where the stocks had peaked and troughed in the past, and which stocks were closest to those peaks and troughs. The entire project was completed the same afternoon.

However, my report wasn't submitted for another two weeks, which was how long it took my fundamental counterpart to complete his report. When both lists were submitted, the funny thing was that we both came up with essentially the same results. He had taken all of the fundamental factors, including historic price/earnings ratios and the like, into consideration to determine his numbers for historic valuations. I simply looked at the price histories of the stocks. We came up with the same numbers, but my task took two hours while his took two weeks. I learned two things from that. First, both approaches often give us the same results, demonstrating the enormous overlap between the two. Second, the chart approach is much quicker and doesn't require much knowledge of the stocks in question.

CHARTS DO LOOK AHEAD

The market is always looking ahead. It is a *discounting mechanism*. We don't always know why a market is rising or falling. When we do find out,

the market often goes in the opposite direction. The tendency of markets to lead fundamental data accounts for most of the discrepancies between the two approaches.

PICTURES DON'T LIE

Since fundamentals are discounted in the market, market analysis is just another form of fundamental analysis—a more visual approach, if you will. Often when I'm asked why a market is rising, I respond by saying that the fundamentals are bullish. I may have no idea what those fundamentals are. But I can feel confident that a rising price signals that the market is taking a bullish view of its fundamentals. It is this very point that makes the case for market analysis so compelling.

It also demonstrates why studying the market visually is such a vital part of the investing process. It suggests why fundamental analysis shouldn't be used in a vacuum. Market analysis can alert an investor to changes in a market's supply/demand equation, which would then prompt a reevaluation of that market's fundamentals. Or, market analysis can be used as a check or filter on fundamental assessments. Either way, there is plenty of room for both disciplines to complement each other's strengths.

PICTURE ANYTHING YOU WANT

One of the greatest strengths of the visual approach to market analysis is its ability to monitor a large number of markets at the same time and to cross over into other investment mediums. It is possible for an investor to chart markets all over the world. Global stock and bond markets, foreign currencies, stock sectors, individual stocks, bonds, and commodities can easily be monitored. In addition, the principles of chart analysis can be applied to any and all of those markets with little knowledge of the respective fundamentals of the markets themselves. Given the trend toward global investing, and the myriad investment choices now available to the individual investor, this is no small achievement. And the beauty of it is that one can do a creditable job of analyzing those markets by mastering a relative handful of visual tools.

THE MARKET'S ALWAYS RIGHT

Charts work for two reasons. First, they reflect the market's assessment of the value of a given stock. How many times have you heard the expression "You can't fight the tape"? If you're bullish on a stock, and it is falling, you're

wrong in your opinion of that stock (or, as forecasters sometimes like to say, “early”). If you are short on the stock and it is rising, you’re wrong again. The market gives us a daily report card. Analysts sometimes say that a market is rising or falling for the wrong reasons (usually when the analyst has been wrong on the stock’s direction). There’s no such thing as a market moving for the wrong reasons. The market is always right. It’s up to us to get in sync with it. I’ve been told a few times in my career that I was right, but for the wrong reasons—usually by someone who was wrong for the right reasons. I’d rather be right for the wrong reasons than wrong for the right reasons any day. How about you?

IT’S ALL ABOUT TREND

The second reason that charts work is that markets trend. If you don’t believe it, look at the chart of the Dow Jones Industrial Average in Figure 1.1. If you’re still not convinced, all you have to do to prove it to yourself is buy a stock that is falling. The existence of a downward trend will be painfully apparent. The study of trend is what visual chart analysis is all about. From this point on, the tools and indicators that we employ will have one purpose in mind—to identify the trend of a stock or market, either up or down. Figure 1.2 shows why it’s important to be able to tell up from down.

ISN’T THE PAST ALWAYS PROLOGUE?

Critics of charting claim that past price data can’t be used to predict the future, or that charts work because of a “self-fulfilling prophecy.” Consider whether the first claim makes any sense: What form of forecasting doesn’t use past data? Doesn’t all economic and financial forecasting involve the study of the past? Think about it. There is no such thing as future data. All anybody has is past data.

If you are concerned about the self-fulfilling prophecy, turn on CNBC or any other news outlet and listen to the conflicting opinions of market analysts. As with any method of forecasting, market analysts often differ as to how they interpret the same data. I’m often asked why charts work. Does it really matter? Isn’t it enough that they do work? Keep in mind that charts are nothing more than a visual history of a stock’s performance. It’s virtually impossible for a stock to trend in any direction without that trend being revealed on the price chart. It naturally follows that if trends can be seen, they can also be acted upon.



FIGURE 1.1 Anyone who doesn't believe that markets trend might want to study this chart of the Dow Industrials. A lot of money was made between 2003 and 2007 by investors who spotted and believed in that four-year uptrend.
Source: StockCharts.com.



FIGURE 1.2 This chart shows an uptrend and a downtrend in one stock. After tripling in price between 2003 and 2005, the homebuilding stock fell a similar amount the following two years. It's important to be able to tell the difference between the two trends.

Source: StockCharts.com.

TIMING IS EVERYTHING

This first chapter intends not only to explain how the visual approach differs from traditional forms of financial analysis, but also to show how they can be blended together. Consider the problem of timing: Suppose your fundamental analysis identifies a stock that appears attractive for purchase. Do you just go in and purchase it? Maybe the analysis is right, but the timing is wrong. In such cases, the application of some basic charting can help determine if now is the best time to begin buying, or if purchases should be deferred until a more opportune time. In this way, the two disciplines can be combined quite nicely.

SUMMARY

The point of this chapter is to present some of the philosophical ground on which visual chart analysis is based and to demonstrate how and why it should be incorporated into one's analysis. The logic and simplicity behind the visual approach is both appealing and compelling. At the same time, it seems worthwhile for anyone just beginning a study of this approach to understand and appreciate its true value.

Consider the plight of someone who doesn't use any form of visual analysis: Picture a bus driver operating the vehicle without looking out the windows and at the rearview mirror. Imagine a surgeon operating on a patient blindfolded or without first looking at an X-ray. Have you ever seen a meteorologist do a weather forecast without maps? All these people are using visual tools and skills. Would you undertake any serious venture with your eyes closed? Would you go on a trip without a map? Why, then, would you consider investing your money in any stock or mutual fund without first looking at a picture of how it is doing?

In the next chapter, we begin showing you what you can see in that picture.

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