

Why Technical Analysis?

IF YOU'VE PICKED UP this book, you're probably at least interested in technical analysis, but perhaps you're not fully convinced that technical analysis should be part of your management plan. Maybe it's not your cup of coffee, or maybe it's just not in your fund's mandate. That's okay. Most funds have fundamentally based analysis and may be slow to accept charting as a valid research tool, or options as valid investments. But every time a strong bear market or significant correction appears—accompanied by a volatility spike—more managers and funds begin to at least consider options and chart patterns.

Stocks tend to move ahead of fundamentals; corporate information and data can be as much as six months behind share movement. By acting on information gained through technical analysis, managers can sometimes prevent a fund from losing profits and/or capital. That's a compelling argument for technical analysis, even for fundamentalists.

Fundamental analysis considers companies in many different ways: Outlook and business operations, balance sheet and income statement, competitive factors, and other variables help analysts create fair market valuations and price targets for underlying shares. Analysts closely monitor the effect of news and other events on a company, but they generally form expectations for periods that exceed nine months and are sometimes as long as 18 months to two years. By the time fundamentals have run their projected or extended courses, share prices may have peaked or turned lower. (In many cases, investors see this as a buying opportunity, which may create a bounce.) Technical analysis can help you predict movements during those projection periods.

If you cannot or will not use technical analysis to make trading decisions, you may at least want to use technical analysis to warn you of potential changes to fundamentals before they happen. Consider using and monitoring monthly charts, and consulting the weekly charts if you see a significant price change.

Consider some examples of how and why this works. Technical analysis works well in part because stock trading is tied to economic factors and cycles, with sectors and industry groups moving higher and lower based on their places in the cycle.

As cycles and economics play out, insiders buy and sell shares in response to changing business expectations. Insiders—everyone from the CEO to a guy on the loading dock—are often good at spotting the factors that affect the company's bottom line. Some of these individuals may not be allowed to trade company stock; others (such as the guy on the loading dock) may not be required to report trades to the Securities and Exchange Commission (SEC), so their transactions go unnoticed.

But officers and other qualified insiders can trade their own companies' stock and must tell the SEC when they do. They notify the SEC—and, through them, the rest of the financial world—through Form 4 filings. In Figure 1.1 we see that seven insiders sold 35,846 shares of stock on June 8. The insiders bought many of those shares by exercising corporate options days earlier.

SEC filings reveal insider trading. Share movements—in both price and volume—show what the so-called smart money is doing. Smart money, in this context, belongs to people who have a close company association. They may be suppliers, customers, partners, service providers, or others with knowledge and opportunities for close observance.

Share movement generally gets the attention of astute investors, managers, and technicians. Price breakouts and other factors associated with stock accumulation often attract new buyers and may bring the first technical signal that the stock is breaking out. As more investors and analysts begin to notice share movement, buying pressure will likely increase, providing the breakout.

Low valuations are common when a stock is beginning to take off. Real and estimated price/earnings ratios and price-to-book readings will also be low, attracting value investors and managers. These leaders usually help attract other buyers.

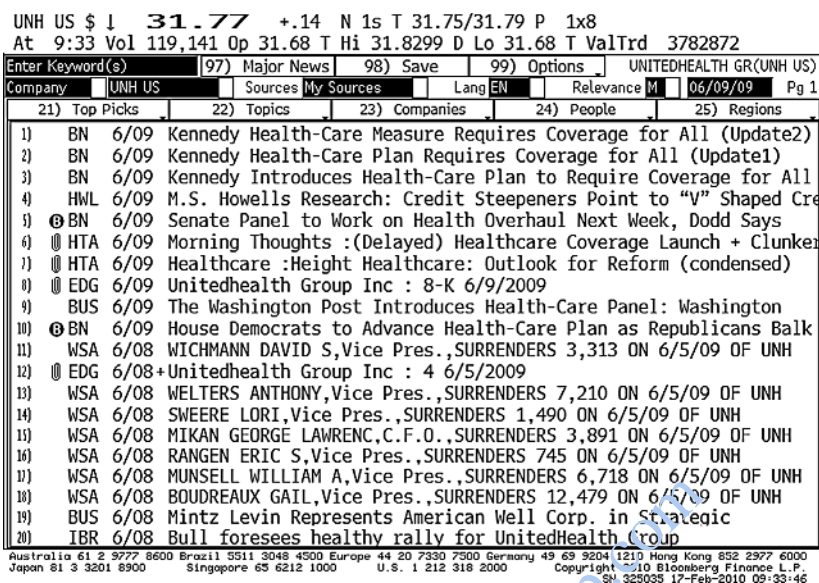


Figure 1.1 This Bloomberg Professional news screen shows the sales of UNH shares being filed with the SEC on June 8.

Most of the buyers that enter the market at this point are not looking to make a quick profit. They are long-term investors who expect a target company's business to grow. They monitor business activity, looking for improvements and checking whether or not their investments stay on track.

Bases

After a company goes through a decline, shares typically go into a low-volatility, sideways trend that's called a base. Trend characteristics include contracting Bollinger Band lines and a low Average Directional Momentum Index (ADX) reading. Share prices may be relatively low compared to the past year or two. Look for basing on a weekly chart rather than a daily chart, because a daily chart's period may not be long enough to show a real base, one that will support a share breakout.

Bases don't always happen, but they're easy to identify and offer useful information, particularly when they last at least one quarter. That happened for Apple Inc. (AAPL), shown in Figure 1.2. Note the stock's sideways movement between October and March on the weekly chart,



Figure 1.2 This Bloomberg Professional chart of Apple Inc. (AAPL) shows the weekly movement and the base that formed between October and March.

a pattern accompanied by waning volume. Measure upward from the base along the x-axis to project a target stock price. The longer the base, the greater the shares' upward potential.

Figure 1.3 shows AAPL after the breakout. Our initial measurement showed that the stock should move to around \$150 from \$101. The stock hit that target nearly three months after the breakout for a gain of nearly 45 percent.

Volatility continued to contract as the base formed, declining on both an implied (based on option premiums) and a historic (based on share movement) basis. Figure 1.4 shows the continuous decline in volatility, even after the stock broke out and rose from the base. (This is a daily chart, not a weekly chart, so we are not showing an apples-to-apples comparison between stock price and volatility.)

The low volatility level indicates that option premiums (and risk perceptions) were comparatively low, which provides an opportunity for would-be investors. Because these investments are generally longer-term, an investor can use the Long-term Anticipation Securities (LEAPS™) as an alternative to purchasing shares. LEAPS are long-term options, initially listed for trading with about 30 months of life until expiration.

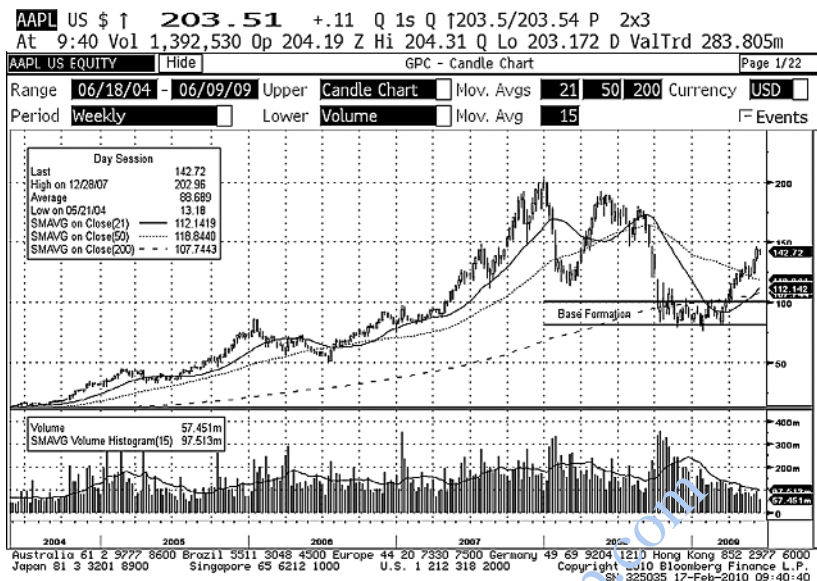


Figure 1.3 Bloomberg Professional chart on Apple Inc. (AAPL) after the breakout. Note how the stock was just below the \$150 initial target price!



Figure 1.4 30-day historic and implied volatility chart on Apple Inc. (AAPL), courtesy of iVolatility.com.

Unlike regular options, these contracts are only on select stocks with higher levels of trading activity, interest, and liquidity.

Advantages include the ability to leverage an investment by putting up less initial capital. Risks include a potential total loss of capital—but this is less than the cost of buying the shares in either a cash or margin

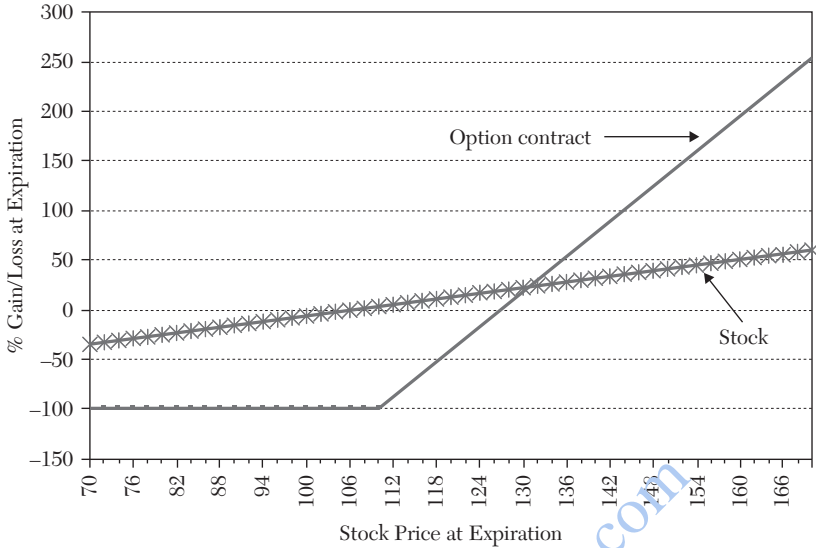


Figure 1.5 Payoff chart for Apple Inc. comparing the stock vs. the purchase of the long-term call option. Returns are based on intrinsic price at expiration. Time premium would likely add additional profit and percentage return prior to expiration.

account. Consider buying options that are equivalent to the stock you might otherwise have purchased, then investing the remainder in a low-risk instrument, such as a Treasury bond.

As shown in Figure 1.5, AAPL was at \$106.85 as the breakout began. A call option with a \$110 strike price and nearly nine months until expiration cost \$17. When the stock reached \$146.40 on June 8, that option's price was \$39.20. The unrealized gain was \$22.20 per share, or 130.6 percent, compared to a potential gain of \$39.55 per share, or 37 percent. Notice that the leveraged option return was nearly 3 1/2 times that of the stock. These returns don't include the approximate 2 percent gain from owning Treasury securities.

Fundamentals vs. Technicals

For value investors, technical analysis may have helped confirm expectations that business conditions would improve. Insiders and those in the know began to accumulate stock with the expectation that business would improve later in the year.

The base's beginning shows that insiders bought 22,359 company shares in two transactions. Several weeks later insiders sold small share blocks, then bought another 33,296 shares in late January. After the breakout insiders bought another 1,204 shares, and one insider sold nearly 8,000 shares.

One might say that we missed the bottom by waiting for the breakout—but we weren't trying to find the bottom. It's impossible to consistently find stock price bottoms, and doing so may mean tying up capital in positions that resolve slowly. By giving up a small amount of profit potential, we raise the probability of making a correct investment decision.

As I noted earlier, basing patterns are usually most effective when they take several months to form. Growth over one or two quarters provides a nice base and plenty of upside potential. The longer the base, the greater the shares' potential upward movement. However, investors who own positions during the basing period commit capital and may sacrifice other opportunities, especially if shares remain stagnant for an extended period of time. A stock's sideways trend might last for more than a year, giving market underperformance in a bull market and sometimes even in a bear market. Such trends contribute little to fund performance or investor loyalty.

Investors who buy long calls on a breakout see varying times to profitability. In some patterns a decline to the breakout point may follow the breakout; the market tests that price point before the positive trend resumes. This is a new buying opportunity for those that missed the breakout, or for those who bought partial positions. Once the positive trend resumes, the pattern confirms that the breakout was not a false event. Exit the position if the breakout point is violated and shares go back into the sideways trend pattern or (worse) break the support.

A positive breakout affirmation should bring positive news from the company—if not immediately, then in the near future. This should increase trend momentum. A failed breakout suggests that fundamental analysts should look for reasons that the stock is failing. If the stock continues to move lower on positive news, something is wrong.

Maintaining the long call position is important. Doing so lowers the position's risk and helps maintain market interest, and therefore liquidity. Generally, however, investors take action on a stock position that moves higher by at least 10 percent. In this situation a manager might sell

the long call and roll it into another long call in the same expiration month, but at a higher strike price. The premium is less tied to the sold contract's economic value, so the move typically takes out most of the initial capital and some profit, leaving a position with reduced capital exposure.

A manager might also sell an out-of-the-money call option with a closer expiration date, especially if the implied volatility level has risen and the skew shows higher implied volatility on shorter-term than longer-term contracts. This would limit the potential upside, but the premium received by writing these calls would increase profits if upward movement stalls, or if the stock goes into a corrective or consolidation phase.

Tops

Sideways patterns are also possible at tops, although they are less frequent and usually shorter. Implied volatility levels are usually relatively low at tops, because investors may feel complacent following share appreciation. Most investors are slow to sell a stock. They hope shares will continue to rise, and they often feel loyalty toward the company and its shares, especially after a significant gain. When the stock does begin a descent, investors may think the decline is just a correction to the advance and believe that the upward trend will likely resume in the near future.

Tops often involve or anticipate real-time events: a slowdown in orders, higher resource prices, contract loss, and competitive pressures. A health care company, for instance, might face the loss of patent protection for a key product. Decreasing margins, stronger competition, and lower profits will all put the company's future under pressure.

Figure 1.6 is a daily chart on Johnson & Johnson from June 12, 2006 to January 26, 2007. The stock was at a high of \$69.41 on October 23 and then set a marginally lower high on November 7 at \$69.03. An apparent correction/consolidation pattern developed and lasted from mid-October into mid-January, a three-month period.

Figure 1.7 shows that shares complete a short-term head-and-shoulders top, but find support at the consolidation support line. The stock breaks support on February 21, sending shares back toward the June 2006 lows. Volume increases during the decline as momentum increases.



Figure 1.6 Bloomberg Professional chart on Johnson & Johnson (JNJ)—Daily chart from June 12, 2006 to January 26, 2007. Notice the consolidation that formed between November and January. There was even a very short-term head-and-shoulders top that formed toward the end of the consolidation.



Figure 1.7 Bloomberg Professional chart on Johnson & Johnson (JNJ)—Daily chart from June 12, 2006 to March 26, 2007. Notice the break in the consolidation following a head-and-shoulders top pattern. Volume increased on the breakdown.

Implied volatility declined to a low of 10.27 percent—its lowest level in years—before the February 21 breakdown. As the shares broke support, volatility rose to a high of 16.08 percent on March 13. Shares bounced and dropped back to a higher low, but implied volatility didn't retrace to its lows. (It did narrow the space between highs and lows.)

Using long-term options with fundamental analysis works in bearish and bullish scenarios. Investors who use options instead of selling shares short don't have to borrow the shares, pay a rebate, be bought in, or be squeezed if a positive trend resumes. Alternatively, long-term puts may be an attractive purchase for managers who believe that shares may decline in the intermediate to long term. By purchasing a put contract just as the shares break consolidation support, investors get the best opportunity for both timing and pricing. Puts typically cost less when implied volatility levels are near their lows, and would-be short-sellers avoid holding a short position for what might be a long time as they wait for the breakdown.

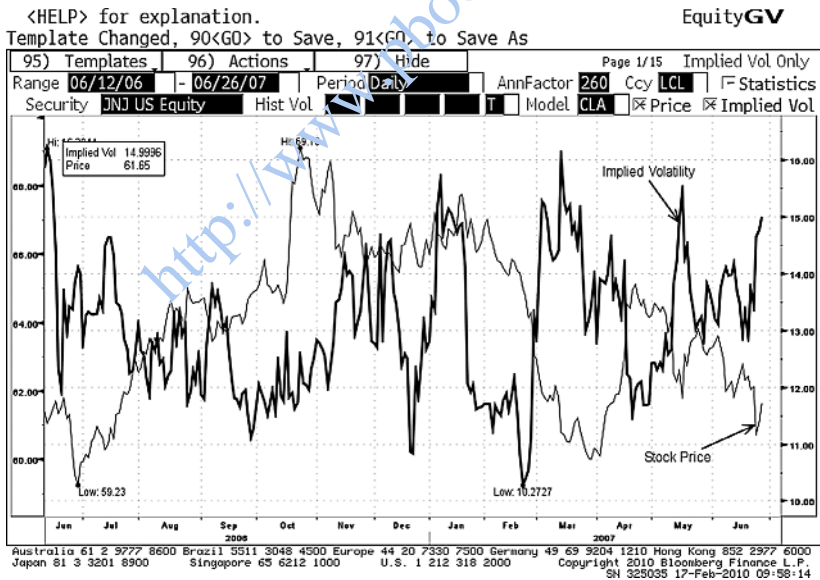


Figure 1.8 Bloomberg Professional chart showing the closing price of the stock and implied volatility on Johnson & Johnson (JNJ) during the period between June 2006 and June 2007.

My arguments for using technical analysis aren't intended to imply that fundamentals don't count. They absolutely do. Technical analysis, however, can offer useful insights at times when a stock is moving in one direction and company expectations are moving in another. It can quickly and efficiently reveal shorter-term events and trends that affect a company's stock and can also offer a time-efficient and economical alternative to primary fundamental research, which typically costs a great deal of time and money—particularly when it's done well. Pair technical analysis with fundamental analysis, by contrast, and you'll get the most for your money, uncovering trends, problems, and opportunities that you might not otherwise see.

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