Chapter 22

Leverage Technical Analysis to Improve Fundamental Analysis

Typical fundamental equity analysts assume that stock recommendations should be based in part (or entirely) on forecasts of *future* earnings or cash flows, whereas technical equity analysts look at stocks' *historical* prices and volumes. At the extreme, they are as different in philosophy as liberals are from conservatives. But, I'd contend that there is common ground: A fundamental equity analyst can use technical analysis techniques to improve stock picking.

I should begin with two notes of caution. During my research for this book, I met a few portfolio managers who use technical analysis with fundamental analysis, but they were adamant about not wanting their analysts to do the same. They were concerned that it would cloud the fundamental call. So, first, be cautious about walking into a portfolio manager's office to exclaim that your favorite stock looks great on a technical basis. (It's worth noting, there are highly regarded sell-side analysts who include technical analysis with their fundamental work.) Second, it should be understood that, due to space limitations, this discussion is

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confined to a small subset of the field. Therefore, if you intend to use it as the primary method for making stock recommendations, it should be explored much further.

While technical analysis can also be used as a *screening tool* to identify investment candidates for further analysis, this best practice explores *how to utilize technical analysis after fundamental analysis has been completed*. To do this, I will first introduce some basic concepts of technical analysis, such as chart construction, trendlines, and oscillators.

Objective Data Can Capture Subjective Emotions

Technicians believe in the power of the free market and the wisdom of the crowd. In a freely traded market, a wide variety of participants come together and collectively determine price through bidding and selling. These participants come with a range of knowledge about a subject company; they may be true insiders (e.g., board members or employees) or knowledgeable outsiders (e.g., buy-side or sell-side analysts). One of the inputs market players likely bring to the table is their fundamental analysis, but this is rarely the only input. As discussed earlier in the book, they also bring their emotions. A simplified assumption of fundamental analysis is that investors are cool, logical, rational individuals ignoring their emotions when valuing securities. While this might be true on the Vulcan Stock Exchange, humans are at times highly emotional creatures, and these emotions invade and influence every aspect of our existence, sometimes significantly. The field of behavioral finance is beginning to recognize the impact of irrational behavior. The field of technical analysis provides the tools to analyze it.

Market participants bring all of the above to bear on the markets. When they trade, the end result of their process, whether logical, emotional, or some combination thereof, becomes publicly available in

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