Learn to Make Profits Using

Technical Analysis

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Pravin Khetan is the Director at iPlan Education. He is a B.com and MBA in International Finance from GITAM Institute of Foreign Trade. He has quality experience of training over 6000+ students. Students included working professionals from over 89 top MNCs and top colleges like FMS, BITS-Pilani, IMT and many more. He is also a corporate trainer. He is having over 7 years of experience in equity research, value investing, derivative strategies, commodity and forex pricing. His core expertise is in risk management and price discovery. A dynamic personality, having excellent understanding of behavioral finance, he spends his leisure time as pro-trader and writing to various prominent blogs.

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Dedicated to

"I would like to dedicate this book to my lovable wife Anjana, she is the best reward from God which I could've ever got from any of my analysis or research. It was her continuous support which helped me in completing this book."

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Chapter 1: Introduction

What is fundamental analysis?

Fundamental analysis is the examination of the underlying forces that affect the wellbeing of the economy, industry groups, and companies. As with most analysis, the goal is to derive a forecast and profit from future price movements. At the company level, fundamental analysis may involve examination of financial data, management, business concept and competition. At the industry level, there might be an examination of supply and demand forces for the products offered. For the national economy, fundamental analysis might focus on economic data to assess the present and future growth of the economy. To forecast future stock prices, fundamental analysis combines **Economic, Industry, and Company Analysis (EIC)** to derive a stock's current fair value and forecast future value. If fair value is not equal to the current stock price, fundamental analysts believe that the stock is either over or under valued and the market price will ultimately gravitate towards fair value. Fundamentalists do not heed the advice of the random walkers and believe that markets are weak-form efficient. By believing that prices do not accurately reflect all available information, fundamental analysts look to capitalize on perceived price discrepancies.

EMH- Efficient Market Hypothesis

An investment theory that states it is impossible to "beat the market" because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. According to the EMH, stocks always trade at their fair value on stock exchanges, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices. As such, it should be impossible to outperform the overall market through expert stock selection or market timing, and that the only way an investor can possibly obtain higher returns is by purchasing riskier investments. Source~ Investopedia.com

If we were all totally logical and could separate our emotions from our investment decisions, then fundamental analysis, the determination of price based on future earnings, would work magnificently. And, since we would all have the same completely logical expectations, prices would change only when quarterly reports or relevant news were released. Investors would seek" overlooked" fundamental data in an effort to find undervalued securities.

The hotly debated" efficient market theory" states that ***A security's price represents everything that is known about the security at a given moment.*** This theory concludes that it is impossible to forecast prices, since prices already reflect everything that is currently known about a security.

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Base of Technical Analysis

If prices are based on investor expectations, then knowing what a security should sell for becomes less important than knowing what other investors expect it to sell for. That's not to say that knowing what a security should sell for isn't important-it is! But there is usually a fairly strong consensus about a stock's future earnings that the average investor cannot disapprove. The big variable in a security's price is the premium or discount investors add to the "correct" price.

> ***History repeats itself and the future can be found in the past.***
>
> ***Just as a weatherman uses past and current weather trends to forecast the weather, investors use technical analysis to forecast prices.***

Technical analysis is the process of analyzing a security's historical prices in an effort to determine probable future prices. This is done by comparing current price action (i.e., current expectations) with comparable historical price action to predict a reasonable outcome. The devout technician might define this process with the cliché "History repeats itself," while others would say that we should learn from the past.

The field of technical analysis is based on three assumptions:

1. The market discounts everything.
2. Price moves in trends.
3. History tends to repeat itself.

1. The Market Discounts Everything

A major criticism of technical analysis is that it only considers price movement, ignoring the fundamental factors of the company. However, technical analysis assumes that, at any given time, a stock's price reflects everything that has or could affect the company - including fundamental factors. Technical analysts believe that the company's fundamentals, along with broader economic factors and market psychology, are all priced into the stock, removing the need to actually consider these factors separately. This only leaves the analysis of price movement, which technical theory views as a product of the supply and demand for a particular stock in the market.

2. Price Moves in Trends

In technical analysis, price movements are believed to follow trends. This means that after a trend has been established, the future price movement is more likely to be in the same direction as the trend than to be against it. Most technical trading strategies are based on this assumption.

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3. History Tends To Repeat Itself

Another important idea in technical analysis is that history tends to repeat itself, mainly in terms of price movement. The repetitive nature of price movements is attributed to market psychology; in other words, market participants tend to provide a consistent reaction to similar market stimuli over time. Technical analysis uses chart patterns to analyze market movements and understand trends. Although many of these charts have been used for more than 100 years, they are still believed to be relevant because they illustrate patterns in price movements that often repeat themselves.

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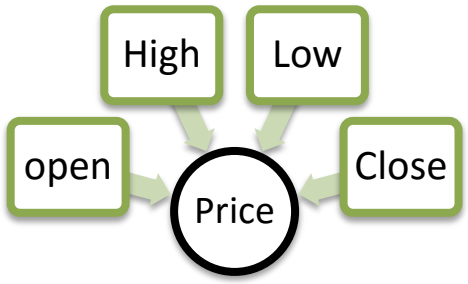
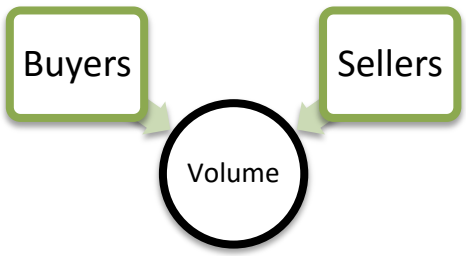
What's common in Stock, Commodity and Forex?

All Trading instruments or assets have 2 things in common- **Price and Volume.**

- Price contains 4 fields – Open, High, Low, Close
- Volume has- Buyer & Sellers

Technical analysis is based almost on Price and Volume. Apart from these factors other fields also work. (i.e. Open Interest, Bid –ask and its spread)





Open-This is the price of the first trade for the period (e.g., the first trade of the day or week or month or may be 5 minutes). When analyzing daily data, the open is especially important as it is the consensus price after all interested parties were able to "sleep on it."

High- This is the highest price at which the security was traded during the period. It is the point at which there were more sellers than buyers [i.e., there are always sellers willing to sell at higher prices, but the high represents the highest price that buyers were willing to pay).

Low-This is the lowest price at which the security was traded during the period. It is the point at which there were more buyers than sellers (i.e., there are always buyers willing to buy at lower prices, but the low represents the lowest price sellers were willing to accept).

Close-This is the last price at which the security was traded during the period. Due to its availability, the close is the price used most often for analysis. The relationship between the open price and the close price is considered significant by most of the Technical Analysts.

Volume- This is the number of shares (or contracts) that were traded during a certain period. The relationship between price and volume is very important- Increase in Price must be accompanied by increase in volume.

Open Interest-The total number of options and/or futures contracts that are not closed or delivered on a particular day.

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A common misconception is that open interest is the same thing as volume of options and futures trades. This is not correct, as demonstrated in the following example:

Time	Trading Activity	Open Interest
Jan 1	**A** buys 1 option and **B** sells 1 option contract	1
Jan 2	**C** buys 5 options and **D** sells 5 options contracts	6
Jan 3	**A** sells his 1 option and **D** buys 1 options contract	5
Jan 4	**E** buys 5 options from **C** who sells 5 options contracts	5

-On January 1, **A** buys an option, which leaves an open interest and also creates trading volume of 1.
-On January 2, **C** and **D** create trading volume of 5 and there are also five more options left open.
-On January 3, **A** takes an offsetting position, open interest is reduced by 1 and trading volume is 1.
-On January 4, **E** simply replaces **C** and open interest does not change, trading volume increases by 5.

Bid-This is the price a market maker is willing to pay for a security (i.e., the price you will receive if you sell).

Ask-This is the price a market maker is willing to accept (i.e., the price you will pay to buy the security).

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Chapter 2: Dows Theory- The foundation

Introduction

The Dow Theory has been around for about 100 years and even in today's volatile and technology-driven markets, the basic components of Dows Theory still remain valid. It was developed by Charles Dow, refined by William Hamilton and then articulated by Robert Rhea; the Dows Theory addresses not only technical analysis and price action, but also the market philosophy.

Charles Dow developed the Dows Theory from his analysis of market price action in the late 19th century. Until his death in 1902, Dow was part owner as well as editor of *The Wall Street Journal*, although he never wrote a book on the subject.

Market Movements

Dow and Hamilton identified three types of price movements for the Dow Jones **Industrial** and **Rail averages**: Primary movements, Secondary movements and Daily fluctuations.

Primary movements It lasts from a couple of months to many years and represents the broad or long trend of the market.

Secondary movements: It lasts from a few weeks to a few months and move counter to the primary trend.

Daily Fluctuations: It can move with or against the primary trend and last from a few hours to a few days, but usually not more than a week.

Primary Movement

Primary movements represent the broad underlying trend of the market and can last from a few months to many years. These movements are typically referred to as bull and bear markets. Once the primary trend has been identified, it will remain in effect until proved otherwise. (We will address the methods for identifying the primary trend later in this article.) Hamilton believed that the length and the duration of the trend were largely indeterminable. Hamilton did study the averages and came up with some general guidelines for length and duration, but warned against attempting to apply these as rules for forecasting.

Dows Theory enables investors to identify the primary trend and invest accordingly. Trying to predict the length and the duration of the trend is an exercise in futility.

Hamilton and Dow were mainly interested in catching the big moves of the primary trend. Success, according to Hamilton and Dow, is measured by the ability to identify the primary trend and stay with it.

Secondary Movements

Secondary movements run counter to the primary trend and are reactionary in nature. In a bull market a secondary move is considered a correction. In a bear market, secondary moves are sometimes called reaction rallies.

Below is a chart illustrating a correction within the confines of a primary bearish trend.

Theory Not Perfect

Hamilton warns that investors should not be influenced by their own wishes. When analyzing the market, make sure you are objective and see what is there, not what you want to see. If an investor is long, he or she may want to see only the bullish signs and ignore any bearish signals. Conversely, if an investor is out of the market or short, he or she may be apt to focus on the negative aspects of the price action and ignore any bullish developments.

Hamilton and Dow readily admit that the Dow Theory is not a sure-fire means of beating the market. It is looked upon as a set of guidelines and principles to assist investors and traders with their own study of the market. The Dows Theory provides a mechanism for investors to use that will help remove some of the emotion.

Even though the theory is not meant for short-term trading, it can still add value for traders. No matter what your time frame, it always helps in identifying

the primary trend. According to Hamilton (writing in the early part of the 20th century), those who successfully applied the Dows Theory rarely traded more than four or five times a year. Remember that intraday, day-to-day and possibly even secondary movements can be prone to manipulation, but the primary trend is immune from manipulation.

The Three Stages of Primary Bull Markets

Hamilton identified three stages to both primary bull markets and primary bear markets. These stages relate as much to the psychological state of the market as to the movement of prices. A primary bull market is defined as a long sustained advance marked by improving business conditions that elicit increased speculation and demand for stocks. A primary bear market is defined as a long sustained decline marked by deteriorating business conditions and subsequent decrease in demand for stocks. In both primary bull markets and primary bear markets, there will be secondary movements that run counter to the major trend.

Stage 1 – Accumulation (Bull Market)

Hamilton noted that the first stage of a bull market was largely indistinguishable from the last reaction rally of a bear market. Pessimism, which was excessive at the end of the bear market, still reigns at the beginning of a bull market. It is a period when the public is out of stocks, the news from corporate America is bad and valuations are usually at historical lows. However, it is at this stage that the so-called **"smart money"** begins to accumulate stocks. This is the stage of the market when those with patience see value in owning stocks for the long haul. Stocks are cheap, but nobody seems to want them.

This is the stage where Warren Buffet stated in the summer of 1974 that now was the time to buy stocks and become rich. Everyone else thought he was crazy.

Stage 2 - Big Move or Public Participation (Bull Market)

The second stage of a primary bull market is usually the longest, and sees the largest advance in prices. It is a period marked by improving business conditions and increased valuations in stocks. Earnings begin to rise again and confidence starts to mend. This is considered the easiest stage to make money as participation is broad and the trend followers begin to participate.

Stage 3 – Excess (Bull Market)

The third stage of a primary bull market is marked by excessive speculation and the appearance of inflationary pressures. (Dow formed these theorems about 100 years ago, but this scenario is certainly familiar.) During the third and final stage, the public is fully involved in the market, valuations are excessive and confidence is extraordinarily high. This is the mirror image to the first stage of the bull market. A Wall Street axiom: When the taxi cab drivers begin to offer tips, the top cannot be far off.

Three stages of Primary Bear Markets

Stage 1 – Distribution (Bear Market)

Just as accumulation is the hallmark of the first stage of a primary bull market, distribution marks the beginning of a bear market. As the **"smart money"** begins to realize that business conditions are not quite as good as once thought, they start to sell stocks. The public is still involved in the market at this stage and become willing buyers. There is little in the headlines to indicate a bear market is at hand and general business conditions remain good. However, stocks begin to lose a bit of their luster and the decline begins to take hold.

While the market declines, there is little belief that a bear market has started and most forecasters remain bullish. After a moderate decline, there is a reaction rally (secondary move) that retraces a portion of the decline. Hamilton noted that reaction rallies during bear markets were quite swift and sharp. As with his analysis of secondary moves in general, Hamilton noted that a large percentage of the losses would be recouped in a matter of days or perhaps weeks. This quick and sudden movement would invigorate the bulls to proclaim the bull market alive and well. However, the reaction high of the secondary move would form and be lower than the previous high. After making a lower high, a break below the previous low would confirm that this was the second stage of a bear market.

Stage 2 - Big Move (Bear Market)

As with the primary bull market, stage two of a primary bear market provides the largest move. This is when the trend has been identified as down and business conditions begin to deteriorate. Earnings estimates are reduced, shortfalls occur, profit margins shrink and revenues fall. As business conditions worsen, the sell-off continues.

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