What is Technical Analysis?

Educational

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There are two main disciplines of security analysis; fundamental and technical. The fundamental approach considers all aspects of a company's business as it relates to the overall economic environment in an attempt to extrapolate the future value of the stock. Where this analysis reveals that the expected value of the company is greater than its stock price, an investment opportunity is found.

Technical analysis considers market activity to reveal significant new information and understand the psychological factors affecting stock price in an effort to predict future prices and trends. The remainder of this essay will seek to better explain what this means.

How is Stock Price Determined?

Simply put, the value of a company is the present value of all the money that the market expects the company to make in the future. The company's value is based upon the earnings value of its assets, which will fluctuate as the economy rises and falls and as the company makes changes to it business. Of course, this calculation presents a good deal of uncertainty, so there is an added component of risk.

What is important in evaluating the earnings potential of any company is information. For each publicly traded company there exists an immense amount of information on that firm's future earnings potential. As new information is made public, the market seeks to 'price in' that information. For example, if a small oil company finds a new source of oil, their earnings potential and value will rise. The increase will occur when the market learns of the new find. On a macro-economic level, another example affecting an oil company will be the price of oil. If oil prices go up, the value of the oil company will also improve as they will be able to enjoy greater profits from the price increase of their commodity.

What is important to understand is that prices change because new information affecting the value of the company, and therefore its stock, comes to the market. The stock market is a forum for debate on what that new information is worth and, every day, market participants argue about stock value by buying and selling stock. Those who sell feel that the company is not worth more than the price they are selling at, and those who buy believe that the information known about the company is worth more than the current market price.

Information, Fear and Greed

It should now be clear that information is key to determining share price. However, it is not the only factor that has an effect. Since the stock market is the product of human decision, our characteristics must also be factors. While many financial theorists argue that all market participants are rational, the reality is that we are not computers and therefore are subject to that thing which sets us apart: emotion.

Emotion causes market participants to make what, with hindsight, are determined to be emotional decisions. Fear causes us to sell stocks because we are afraid they are going lower, and greed causes us to buy stocks because we hope they are going higher. Being afraid and hoping are not rational thought processes, but rather emotional outlets in the pursuit of pleasure and pain. It hurts to lose money, and it feels great to make money.

The results are stocks that go up higher or down lower than the presently available information warrants. Eventually, rational valuation of information takes over and these stocks move toward their fair value, but the process takes time.

The Opportunity

Technical analysts use the trading activity of stocks to understand where new information is being revealed on stocks, and where fear and greed have made the market on that stock get overextended. Just as a doctor uses a cardiogram to reveal what is going on in a patient's heart, technical analysts use the stock chart to understand what is happening in the market.

By understanding how to read a stock chart, anyone can understand any business. Those people who have the highest level of understanding of an individual company's business will have the greatest effect on predicting where a stock is going because they cast their vote in the market by buying or selling the stock. When they do, they leave a trail that the technical analyst follows by looking at the stock chart. They reveal new information by buying or selling enough stock to be noticeable. Then, other market participants cause the stock to overextend because of fear or greed.

We invite you to learn the tools available on this web site to become better at understanding why stocks move and how to predict when they will make significant moves. In doing so, you can become an expert on any business simply by reading market activity. Technical analysis is a powerful tool that really just interprets fundamental analysis and the efficiency of the stock market.