

Trading Strategies

Part I

Fundamental versus Technical Analysis:

Though we have dedicated this article to the explanation/interpretation and even reaping the benefits of the information provided by various types of charts, it would be interesting for the readers to distinguish between fundamental analyses as opposed to technical analysis.

Fundamental analyses probably used by just as many traders that use technical analyses, is an attempt to predict the trend of a stock or commodity by the study of the company's financial situation and prospects. This may involve the use of economic data, for example P/E ratios, balance sheet profit and loss in the case of stocks, and crop reports, import/export figures and world economic data in the case of commodity.

Technical analyses on the other hand involves the examination of price activity, especially price patterns to identify trade opportunities in other words charting and picking off trade signals.

The basic foundations or premises of technical analysis are that a stock's or commodity's current price discounts all information available in the market, that price movements are not random, and that patterns in price movements, in very many cases, tend to repeat themselves or trend in some direction.

A great many number of technical indicators have been developed over the years, including the widely used overbought/oversold indicators such as the Relative Strength Index, and the trend following indicators such as Candlesticks or Point and Figure charts. These will be explained at length in the second part of trading strategies.

A significant amount of time must be spent in learning the principles of technical analysis, and in how to properly interpret the various charts and other technical indicators. In Part I of trading strategies we have outlined the various charting methodologies and interpretation of these charts. It has to be stated that while technical analyses is a very useful tool in trading the markets, no technical indicator is fail-safe.

What Are Charts?

Before we go into the basics of technical analyses, I would just like to talk a bit about charts what they are, which charts are best for interpreting historical data and how one can form them.

A price chart is a graphical plot of prices against a particular timeframe, in statistical terms; a chart is a time series plot.



For example the above chart shows along the y-axis the prices of IBM stocks against the x-axis the corresponding dates. Also specified here is the date and time together with the open, high, low, last prices recorded.

Technicians, technical analysts and chartists use charts to analyze a wide array of securities and forecast future price movements. The word "securities" refers to any tradable financial instrument or quantifiable index such as stocks, bonds, commodities, futures or market indices. Any security with price data over a period of time can be used to form a chart for analysis.

While technical analysts use charts almost exclusively, the use of charts is not limited to just technical analysis. Because charts provide an easy-to-read graphical representation of a security's price movement over a specific period of time, they can also be of great benefit to fundamental analysts. A graphical historical record makes it easy to spot the effect of key events on a security's price, its performance over a period of time and whether it's trading near its highs, near its lows, or in between.

Why Use Charts:

Each trader or investor must evaluate chart analysis individually and come up with his or her own trading strategy. Charts are considered as a priceless trading tool by many successful traders, new traders should be cautious of outrightly rejecting this approach simply on the basis of intuitive skepticism.

Some of the principal potential benefits derived from using charts are listed below.

- Charts provide a detailed price history- an essential item of information for any trader.
- Charts can provide the trader with a good sense of the market's volatility, an important aspect when assessing risk.
- Charts maybe used by Fundamental analyst too. Using long term price charts they can assess/isolate periods of major price movements. Analyzing these periods of high volatility Fundamental analyst can home in on the very factors/events pertaining to those periods to identify the causality of such price behaviour. This then can be used to construct a price behaviour model.
- Charts can be used as a timing tool. Anticipation of an end to a downward trend or an upward trend can be a signal to initiate a trading.
- Charts can be used as a money management tool, helping to identify stop points.
- Experienced traders can use charts to uncover certain price patterns which can be used to anticipate price moves and trading signals.
- Knowledge of chart concepts is an essential prerequisite for developing profitable technical trading systems.

Choosing a Timeframe:

The timeframe used for forming a chart depends on the compression of the data: intraday, daily, weekly, monthly, quarterly or annual data. The less compressed the data is, the more detail is displayed.



Daily data is made up of intraday data that has been compressed to show each day as a single data point, or period. Weekly data is made up of daily data that has been compressed to show each week as a single data point. The difference in detail can be seen with the daily and weekly chart comparison above. 100 data points (or periods) on the daily chart is equal to the last 5 months of the weekly chart, which is shown by the data displayed above marked in the rectangle. The more the data is compressed, the longer the timeframe possible for displaying the data.

It would be appropriate at this point to state how individual charts and their respective timeframes are preferred by various market participants.

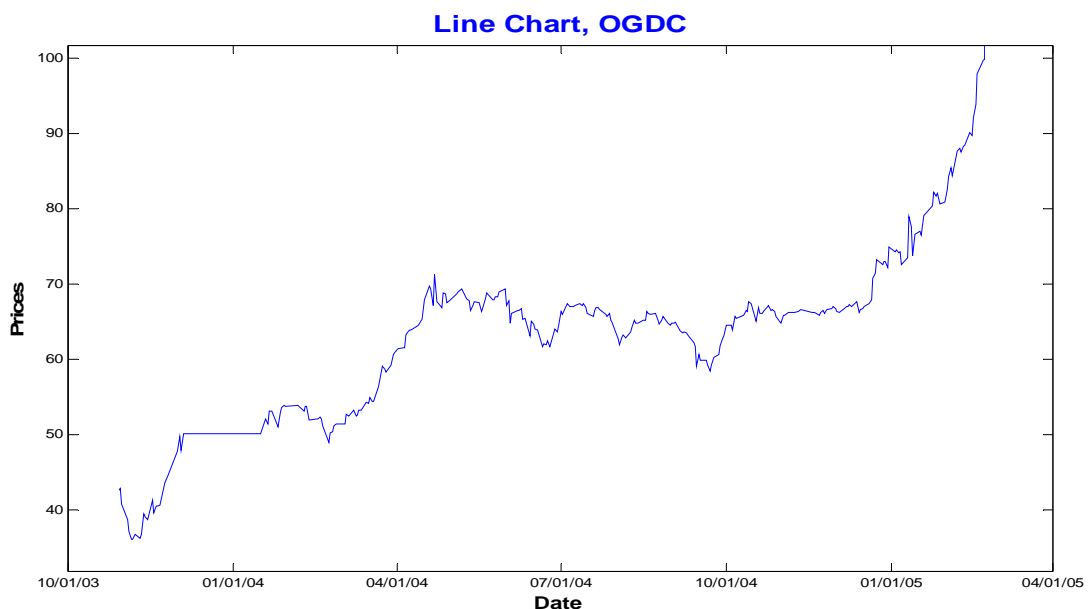
- Traders usually concentrate on charts made up of daily and intraday data to forecast price movements in the short run. The shorter the time frame and the less compressed the data is, the more detail that is available. While detailed in price patterns, short-term charts can be volatile and contain a lot of noise. Large sudden price movements, wide high-low ranges and price gaps can affect volatility, which can distort the overall picture.
- Investors usually focus on weekly and monthly charts to spot long-term trends and forecast long-term price movements. Because long-term charts (typically 1-4 years) cover a longer timeframe with compressed data, price movements do not appear as extreme and there is often less noise.
- Others might use a combination of long-term and short-term charts. Long-term charts are good for analyzing the large picture to get a broad perspective of the historical price action. Once the general picture is analyzed, a daily chart can be used to zoom in on the last few months.

Types of Charts and How They Are Formed:

In this section we will explain the construction of line, bar, candlestick and point & figure charts. Although there are other methods available, these are four of the most popular methods for displaying price data.

Line Chart:

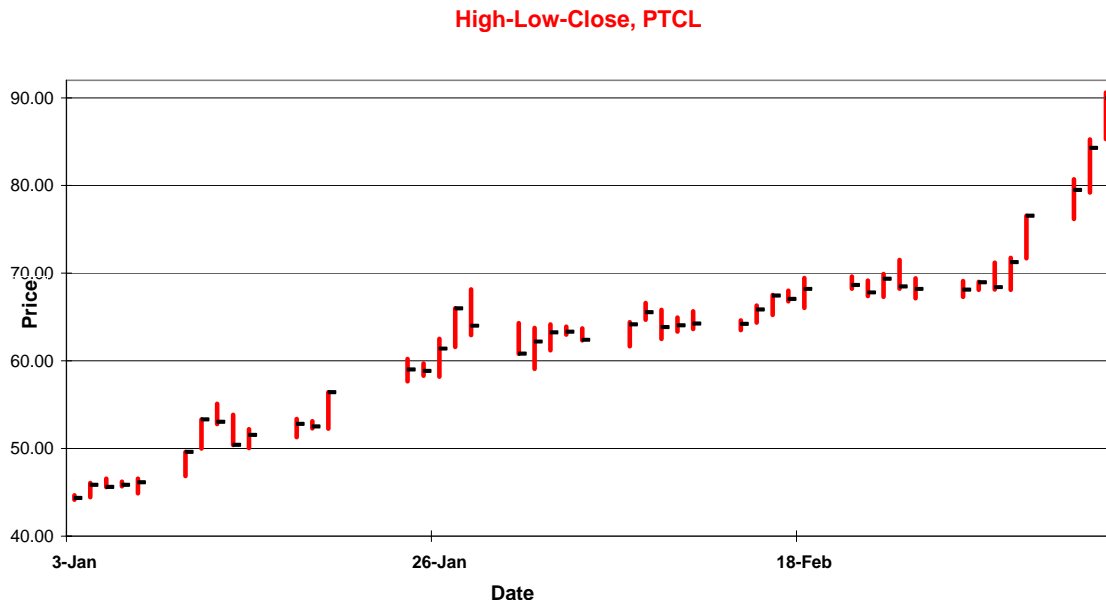
The line chart is one of the simplest charts. It is formed by plotting one price point, usually the close, of a security/commodity over a period of time. Connecting the dots, or price points, over a period of time, creates the line.



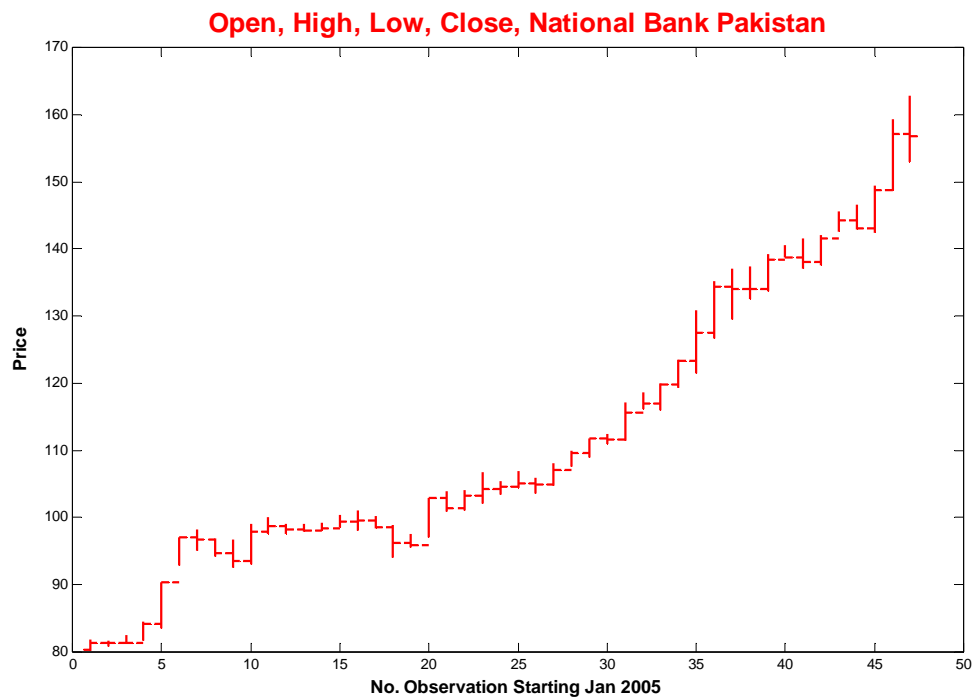
Increasingly open, high, low, closing prices are plotted, but line charts are extremely useful when only one set of data is available. Also intraday swings can be ignored if only the closing prices are considered.

Bar Chart:

Perhaps the most popular charting method is the bar chart. The high, low and close are required to form the price plot for each period of a bar chart. The high and low are represented by the top and bottom of the vertical bar and the close is the short horizontal bar and the open is the short horizontal line crossing the vertical bar. On a daily chart, each bar represents the high, low and close for a particular day. Weekly charts would have a bar for each week based on Friday's close and the high and low for that week.



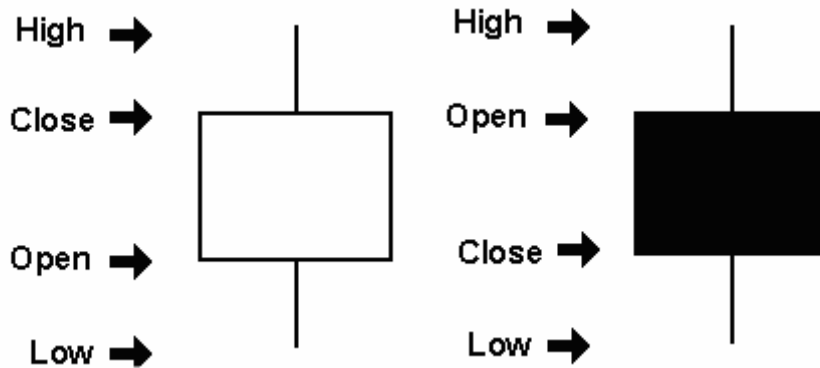
Bar charts can also be displayed using the open, high, low and close. The only difference is the addition of the open price, which is displayed as a short horizontal line extending to the left of the bar. Whether or not a bar chart includes the open depends on the data available.



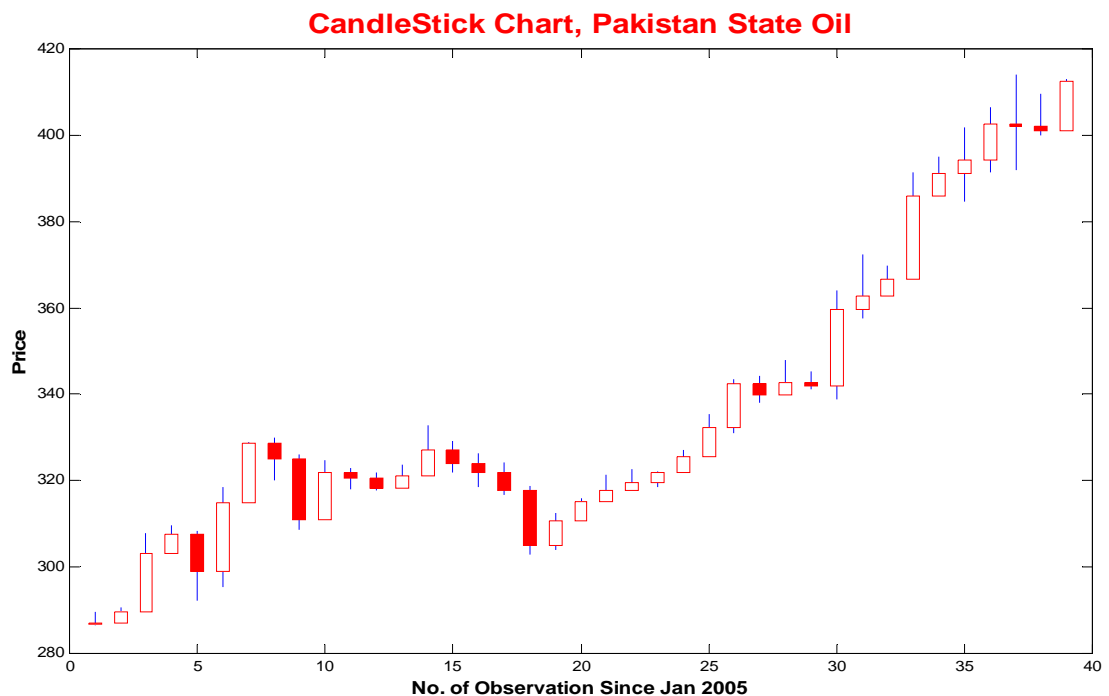
Bar charts can be effective for displaying a large amount of data. Using candlesticks, 200 data points can take up a lot of room and look cluttered. Line charts show less clutter, but do not offer as much detail (no high-low range). The individual bars that make up the bar chart are relatively skinny, which allows users the ability to fit more bars before the chart gets cluttered. If you are not interested in the opening price, bar charts are an ideal method for analyzing the close relative to the high and low. In addition, bar charts that include the open will tend to get cluttered quicker. If you are interested in the opening price, candlestick charts probably offer a better alternative.

Candlestick Chart:

Originating in Japan over 300 years ago, candlestick charts have become quite popular in recent years. For a candlestick chart, the open, high, low and close are all required. A daily candlestick is based on the open price, the intraday high and low, and the close. A weekly candlestick is based on Monday's open, the weekly high-low range and Friday's close.

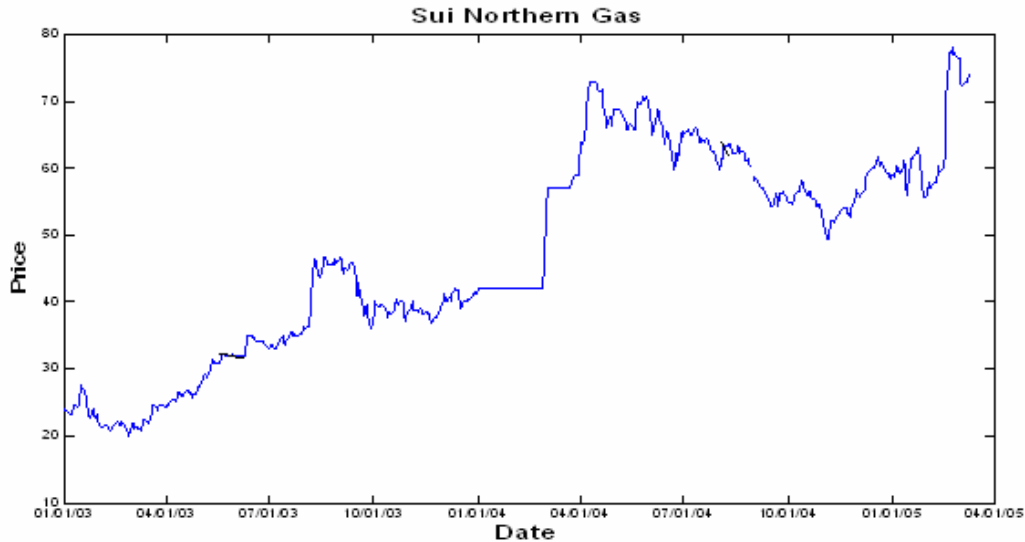


Many traders and investors believe that candlestick charts are easy to read, especially the relationship between the open and the close. White (clear) candlesticks form when the close is higher than the open and black (solid) candlesticks form when the close is lower than the open. The white and black portion formed from the open and close is called the body (white body or black body). The lines above and below are called shadows and represent the high and low.



Basics of Technical Analyses:

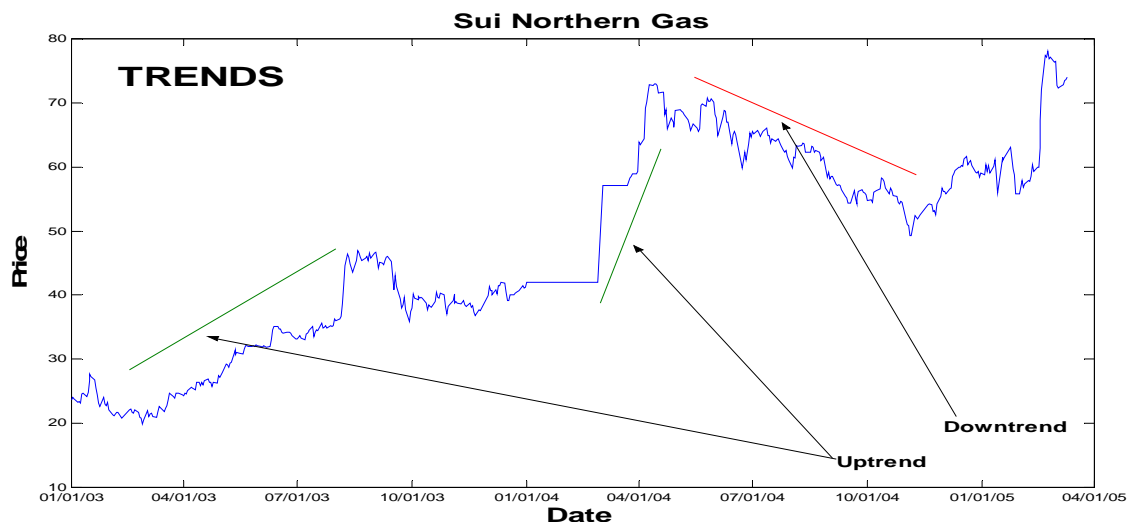
By considering stock charts of KSE listed companies we shall try to explain the various aspects of technical analysis.



Stock charts become popular during the late 19th Century from the writing of Charles H. Dow in the wall Street Journal. His comments later known as "Dow Theory", suggested that market movements display all kinds of measurable trends and that these trends could be deciphered and predicted in the price movement seen on all charts.

Stock chart analysis can be applied equally to individual stocks/commodities and major indices. Analysts may be able to deduce whether the current market is a BULL Market or a BEAR MARKET based on their technical research on index charts. Likewise, investors and traders maybe able to learn the same if not more, about their chosen commodity or favourite company.

Trends:



One can use the stock/commodity chart to identify the current trend. A trend reflects the average rate of change in a stock's or a commodity's price over time. Trends exist in all time frames and all markets. Day traders can establish the trend of their particular chosen commodity or stock to within minutes. Long term investors watch trends that persist for many years.

Trends can be classified in three ways: **UP**, **DOWN** or **RANGEBOUND**.

In an uptrend, a stock/commodity rallies often with intermediate periods of consolidation or movement against the trend. In doing so, it draws a series of higher highs and higher lows on the chart. In an uptrend, there will be a *POSITIVE* rate of price change over time. The above figure illustrates the uptrend and down trends at various time periods of the Sui Northern Gas Company.

In a downtrend, a stock/commodity declines often with intermediate periods of consolidation or movement against the trend. In doing so, it draws a series of lower highs and lower lows on the chart. In a downtrend, there will be a *NEGATIVE* rate of price change over time.

Rangebound price swings back and forth for long periods between easily seen upper and lower limits. There is no apparent direction to the price movement on the charts and there will be *LITTLE* or *NO* rate of price change.

Trends tend to persist over time. A stock or commodity in an uptrend will continue to rise until some change in value or conditions occurs. Declining stocks or commodity will continue to fall until some change in value or conditions occurs. Chart readers try to locate *TOPS* and *BOTTOMS*, which are those points where a rally or a decline ends. Taking a position near a top or a bottom can be very profitable.

Trends can be measured using *TRENDLINES*. Very often a straight line can be drawn *UNDER* three or more pullbacks from rallies or *OVER* pullbacks from declines. When price bars then return to that trendline, they tend to find *SUPPORT* or *RESISTANCE* and bounce off the line in the opposite direction.

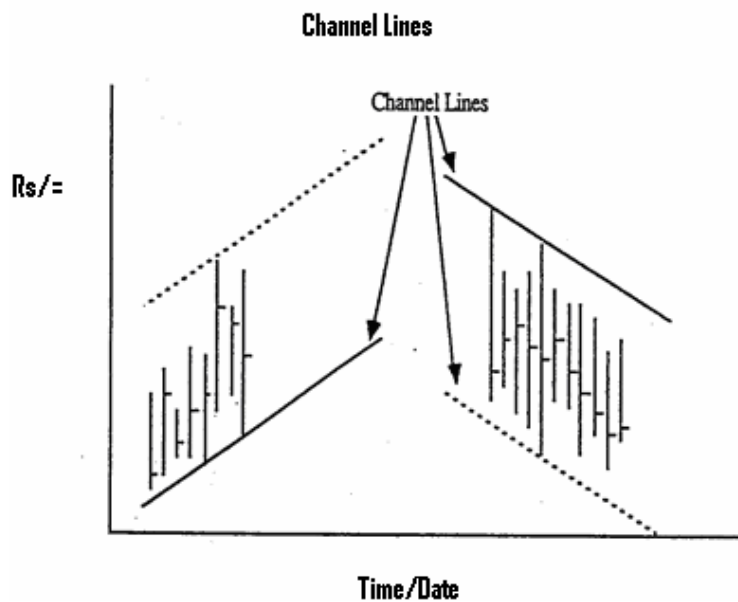
A famous quote about trends advises that "*The trend is your friend*". For traders and investors, this wisdom teaches that you will have more success taking stock positions in the direction of the prevailing trend than against it.

Trends pertaining to the Futures Markets:

Technical analysis makes use of various charting tools and rules to forecast short-term price behavior as we have shown in the first half of this article. These tools also include moving averages of futures prices, bar charts, point and figure charts, volume and open interest in the futures market, price cycles, and rules to interpret chart patterns. Computer software programs may be used to facilitate data collection and interpretation for technical analysis. Some analysts do their own charting, or follow commercial data screen charts while others are comfortable with weekly charting service charts.

Futures prices tend to follow accepted rules of charting and other technical analysis tools because those rules are understood and used by a large number of professional traders. Trading actions that are based on the rules cause the rules to work.

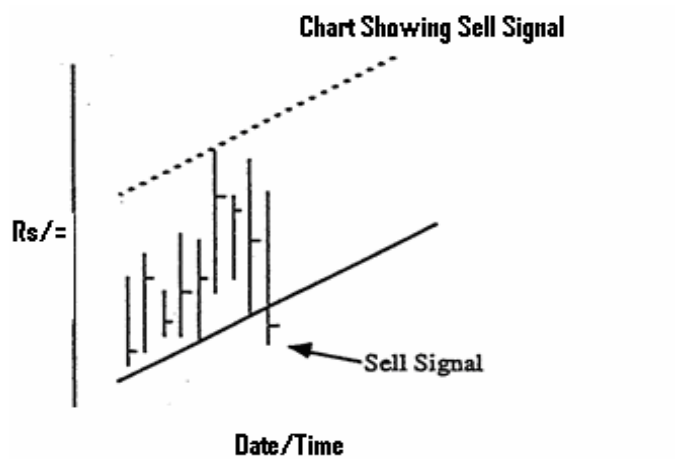
Technical analysis can also be used to guide market timing and forecast short-term price movements. It can also be a guide for hedging, cash contracting, lifting hedges, and placing stop orders.



Channel lines:

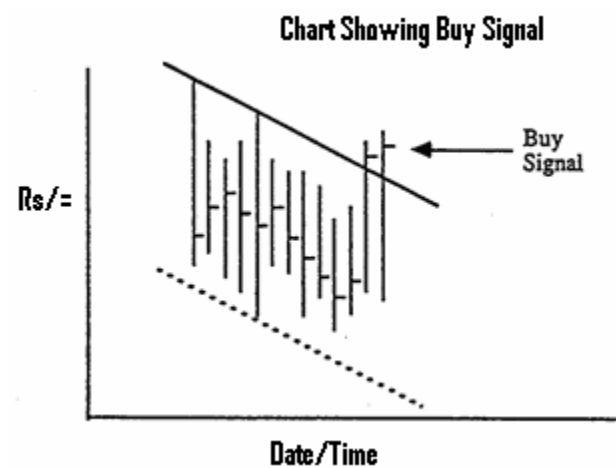
When prices have been plotted over a period of several days or weeks, the price trend can be identified by channel lines. If price trends are up, the base of the channel is drawn as a straight line just touching the two lowest possible points on the price movement. The upper channel line is then drawn parallel to the base and just touching the highest price in the series being charted, as illustrated in Figure above.

If prices are trending downward, the first channel line should be a straight line just touching the two highest possible prices in the series. The lower channel is drawn parallel to the top line and just touching the single lowest price of the series being charted. As long as prices within the two channel lines, the price trend remains intact.



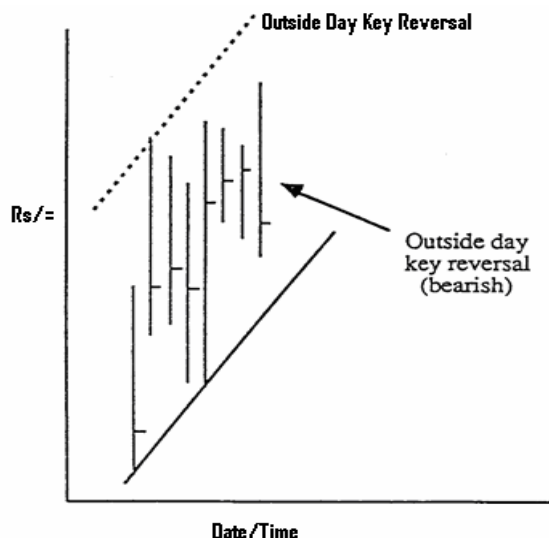
Buy and sell signals:

Professional commodity traders watch the charts for signs of a change in the direction of price movement. One close below the channel is a signal that prices may work lower and is a sell signal for the professional speculator. The figure above shows a sell sign, with the future price closing below the bottom of the channel line. Figure below shows a buy signal, two closes above the channel line. That is a strong indication that prices are about to move higher.



Key reversal or outside day key reversal:

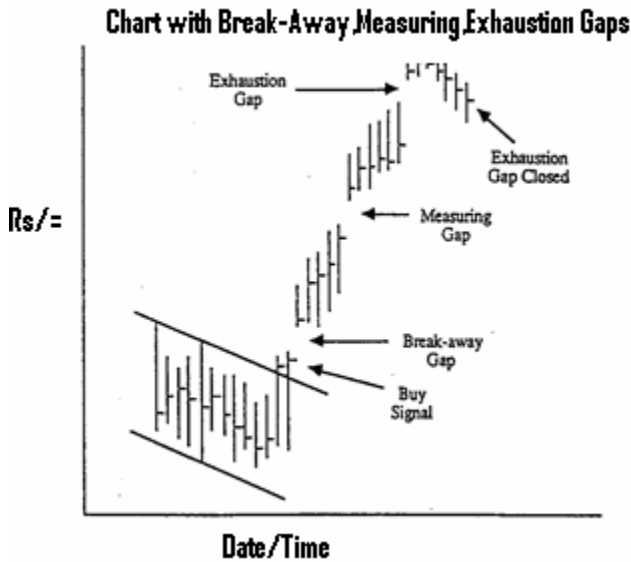
A key reversal is identified by daily high and low prices that exceed the high and low prices for the previous two trading days. With a bearish key reversal, the close is below the closing prices of the previous two days. The figure below shows a bearish outside day key reversal. This information is a caution sign that prices may begin to work lower. A key reversal would be bullish, indicating higher prices, if the close exceeded closing prices for the previous two trading days. Key reversals often appear near the top or bottom of an extended price move.



Gaps:

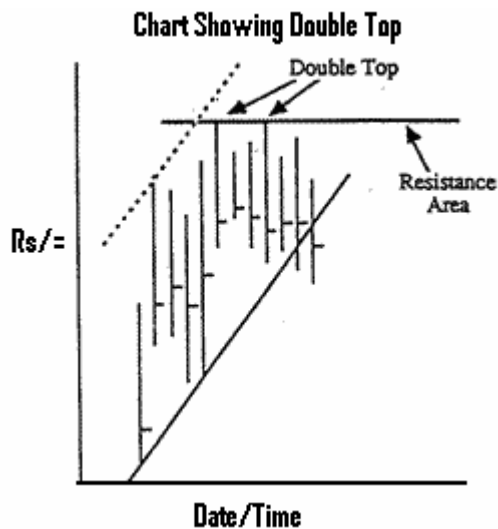
A gap occurs when futures prices suddenly drop, with the high price for the day being below the previous day's low or with prices moving abruptly higher with the day's low exceeding the previous day's high. Examples of gaps are illustrated in the following figure. Trading rules and trading history indicate that gaps will eventually be filled. A gap is filled if prices later trade in the range at which the gap occurred. Since gaps are usually filled, they become price objectives for the chartist who is considering either speculative or hedging trades in the market.

There are several important kinds of gaps. Break-away gaps like those shown on the chart occur at the start of a major new price move and are a strong confirmation of that move if they are not filled within the next few days. Measuring gaps identify the halfway point in a price move, but are much easier to identify from hindsight than from foresight. Exhaustion gaps represent the final phase of a lengthy price move and may indicate the market is about to peak out. When an exhaustion gap closes it could be signaling downward price movement.



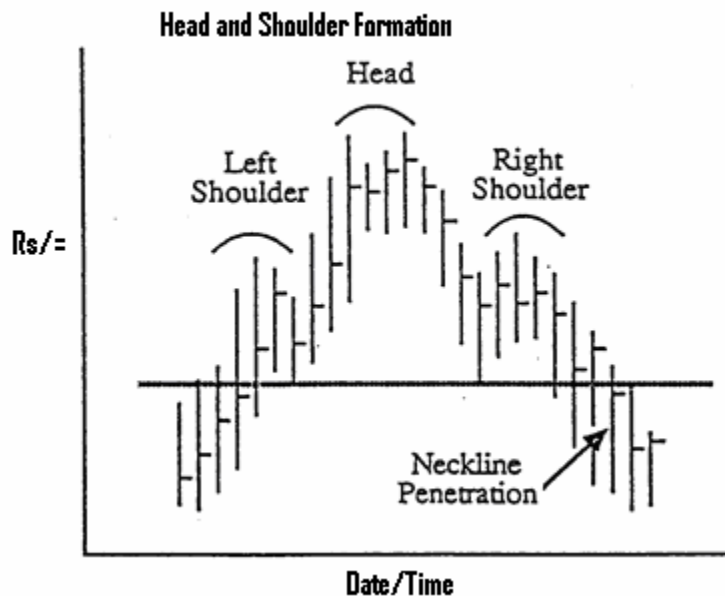
Double tops and double bottom

The next figure shows a double top formation, indicating prices have reached their peak and are about to decline. Double bottoms are the inverse of double tops and indicate prices may be ready to change from a down-trend to an up-trend. Triple tops and bottoms are even stronger indications of a potential change in price trends.



Head and Shoulders Formation:

A typical head and shoulders formation is shown in the figure below. This formation is difficult to spot until it is about two-thirds completed. Once the head has been formed, the chartist anticipates prices will retreat to the neckline, then rise to form the right shoulder, then retreat to the original break-out level where the left shoulder began. These various signals can be guides to price forecasting and price action for individuals who understand and have confidence in their own interpretation of them.



Charting is a useful market tool in deciding when to sell. You may watch for gaps on the charts to help you establish price goals. However, charts are not necessarily the full answer to your marketing needs. Effective crop and livestock marketing requires information about supply and demand conditions in Pakistan and around the world in order to accurately evaluate price prospects several months into the future. Charts are oriented toward short-term price movements because they were developed by professional speculators trading in and out of the market for short-term gains.

Both fundamental and technical analysis can help you project price levels and trends. Combining both kinds of analysis may be particularly helpful. Fundamental analysis will provide an indication of the general price level that can be expected over intermediate time periods, while technical analysis may be especially helpful in forecasting futures market price trends and short term or current price movements and in making decisions about forward pricing.

