

A comment on Investment Basics XLV. Technical analysis – breaking-out on an upward trend? by MB Cohen

Mr Cohen's useful note in *The Investment Analysts Journal* No 55 reflects the negative view held by some academics and others towards technical analysis. This opposition to technical analysis may stem from the original elaboration of the Efficient Market Theory, essentially in the 1970's, where the market was held by many universities to be completely efficient, with no opportunities for above average results. But this hard-line position has now significantly broadened out to admit at least limited inefficiencies, and those who oppose technical analysis should look at the matter again.

The real position is of a dramatic nature. Technical analysis is not so much compatible with the Efficient Market Theory: it *is* the Efficient Market Theory. Mr Cohen sets out the principle of technical analysis involved, that the market discounts everything. But that is just what the Efficient Market Theory says!!! Why there was an opposition between technical analysts on the one hand and the Efficient Market proponents on the other hand is a mystery to me. They should have embraced one another - in a sense, technical analysis was the human science developed in advance of the more rigorous science, enabled by computers, which led to the Efficient Market Theory.

Many of the methods of Modern Portfolio Theory are now seen as technical in the chartist sense. For example, one of the principal tools of the technician has been relative strength analysis, which parallels the use of betas - which are of course calculated on the basis of the relative strength of an individual share as compared with a market index. Mr Cohen's article may put perhaps too much emphasis on the charts of past market action (following the definition by Reuters). In fact technicians take the widest possible view, and use any tool which is available to observe what investors are doing. This can now also be carried out by computers, and as the use of computer techniques becomes more sophisticated it may well be that the techniques of the technical analysts will be superseded by something more exact, in the context of Modern Portfolio Theory. But this may take a little time (as with the development of a computer that can always win at chess) - markets are a human phenomenon with changing characteristics, which the human brain and eye may be able to follow more intelligently and flexibly than a machine which (at the moment at any rate) has in most cases to be programmed in advance.

Mr Cohen mentions that chartists can accommodate behavioural finance and it has always been true that although chartists hold that the markets discount everything they are well aware of the fact that the "everything" may sometimes mean less valid ideas and emotions. The Efficient Market Theory is beginning to accommodate this type of misinformation as well, and this is another example of an area where the technical analysts are on the right track and have led the way.

It appears that both the Efficient Market Theory and the principles of technical analysis point to a certain downgrading of fundamental analysis. But since (as it is now recognised) the markets are not always efficient and since behaviour is not always rational, only a very unwise investor would abandon fundamental analysis. Indeed there are some areas in which fundamental analysis may be more powerful and directly useful than in others: for example, in the shares of small and medium sized enterprises where the market price may certainly not be efficient. In the fact of the necessity, which unfortunately surrounds our profession, of needing to estimate an uncertain future every day and even every hour of our working lives, it would indeed be foolish to omit any of the techniques which might be of help, and we should all make as much use as possible of Modern Portfolio Theory, of fundamental analysis and of technical analysis.

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