NPTEL

Course Name: Security Analysis and Portfolio Management

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Session 19: Technical Analysis-I

1. What is Technical Analysis?

Ans.

- Involves the examination of past market data such as prices and the volume of trading, which leads to an estimate of future price trends and therefore an investment decision. It believes that using data from the market itself is a good idea because the market is its own best predictor.

2. What are the various assumptions of Technical Analysis?

Ans.

Underlying Assumptions of Technical Analysis:

- The market value of any good or service is determined solely by the interaction of supply and demand
- Supply and demand are governed by numerous factors, both rational and irrational
- Disregarding minor fluctuations, the prices for individual securities and the overall value of the market tend to move in trends, which persist for appreciable lengths of time
- Prevailing trends change in reaction to shifts in supply and demand relationships and these shifts can be detected in the action of the market

3. What are the various indicators of Technical Analysis?

Ans.

Technical Trading Rules and Indicators: It believes that using data from the market itself is a good idea because the market is its own best predictor.

- Contrary-Opinion: Trading Against Crowd. Many analysts rely on rules developed from the premise that the majority of investors are wrong as the market approaches peaks and troughs. Technicians try to determine whether investors are strongly bullish or bearish and then trade in the opposite direction.

- Smart Money: Attempts to emulate astute investors. Major indicators includes: Confidence Index, T-Bill-Eurodollar Yield Spread, Debit balances in Brokerage Accounts

- Other Popular Market Indicators: Mutual fund cash positions, Credit Balances in Brokerage Accounts, Investment Advisory Opinions and the Ratio of Trading Volume, Put –Call Ratio and Future Traders Bullish on Stock Exchange Futures

- Stock Prices and Volume Techniques including Dow Theory

4. What are the Advantages of Technical Analysis?

Ans.

- Not heavily dependent on financial accounting statements and free from lack information needed by security analysts
- Non-quantifiable factors do not show up in financial statements
- Fundamental analyst must process new information and quickly determine a new intrinsic value, but technical analyst merely has to recognize a movement to a new equilibrium
- Technicians trade when a move to a new equilibrium is underway but a fundamental analyst finds undervalued securities that may not adjust their prices as quickly

5. Can technical analysis bring efficiency in the portfolio selection process?

Ans.

Technical Trading Rules and Indicators: Stock cycles typically go through a peak and trough.

Challenges to Technical Analysis:

- Assumptions of Technical Analysis
  - Empirical tests of Efficient Market Hypothesis (EMH) show that prices do not move in trends
- Technical Trading rules
  - The past may not be repeated
  - Patterns may become self-fulfilling prophecies
  - A successful rule will gain followers and become less successful
  - Rules require a great deal of subjective judgment