# Sound advice from a chartist

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Five ideas to help you get started using technical analysis.

**By Robert Brain, ATAA**

So you are thinking about investing in the sharemarket and not sure where to start, or perhaps looking around for a change from the failed methods of the past. Perhaps you are looking for the best way to analyse a company. Where to start?

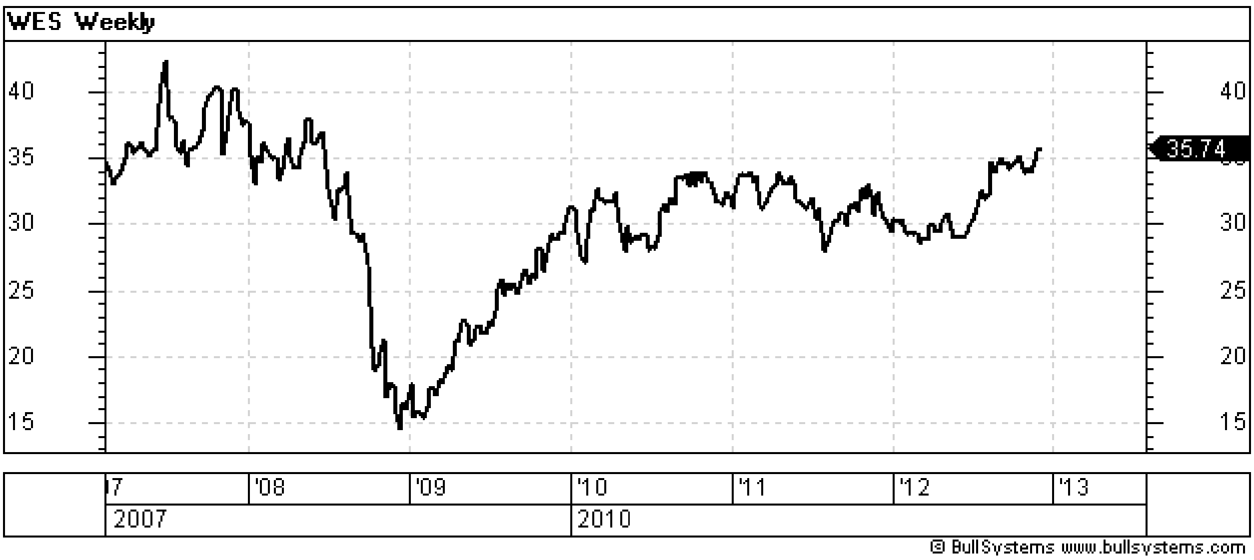
This article suggests five sensible and logical steps, using technical analysis (charting) along the path to success in the sharemarket. But beware of skipping any of the steps because they are all equally important.

**Step 1 - be open to fresh ideas**

Since the end of the last great bull market in late 2007, many people have found that some of the old investment principles no longer seem to apply. They need to adapt their thinking and approach to the current market environment.

The first thing is not to accept everything as gospel. Many people don't realise that even the price of blue-chips can fall as much as 50 to 70 per cent during a bear market, and not make new highs for more than five years. For example, look at the weekly chart of Wesfarmers below (typical of most companies in the Top 50 index).

**Wesfarmers Ltd (WES) weekly chart - 2007 to 2012**




*Source: © December 2012, Robert Brain, Brainy's Share Market Toolbox*

*(larger versions of the charts available)*

The more-nimble investor can spot a falling share price, liquidate a position and put the investment capital to work in a much more profitable way - either a rising share, or a different asset class.

We often hear people say, "But I am living off the fantastic dividend yield". Many investors avoid liquidating their position because they are relying on the dividend payments, which produce a better dividend yield the more the share price falls. In many cases, this is simply a lazy excuse. We could compare the two options: (a) keeping the shares and dividend while the share price falls, versus (b) liquidating and re-investing the capital elsewhere. In many cases option (b) can be shown to be a more sensible approach than watching our investment capital value being destroyed.

**The investors who count**

The daily press often refers to the fears of investors that are directly reflected in the sharemarket. Although it is true that underlying investor fear and sentiment is reflected in prices, the daily movements of at least the large-cap companies are not influenced by the regular retail investors. It is the institutional investors and the big-pocketed day traders on the institutional trading desks that move the prices. And these big guys are often overseas institutions.

Many retail investors do not make investment decisions, and take action on them, on the same day that news hits the markets. They simply react to the actions of the much quicker and larger investors who have very deep pockets and who have a lot of skin in the game - upwards of many hundreds of thousands of dollars per sharemarket position.

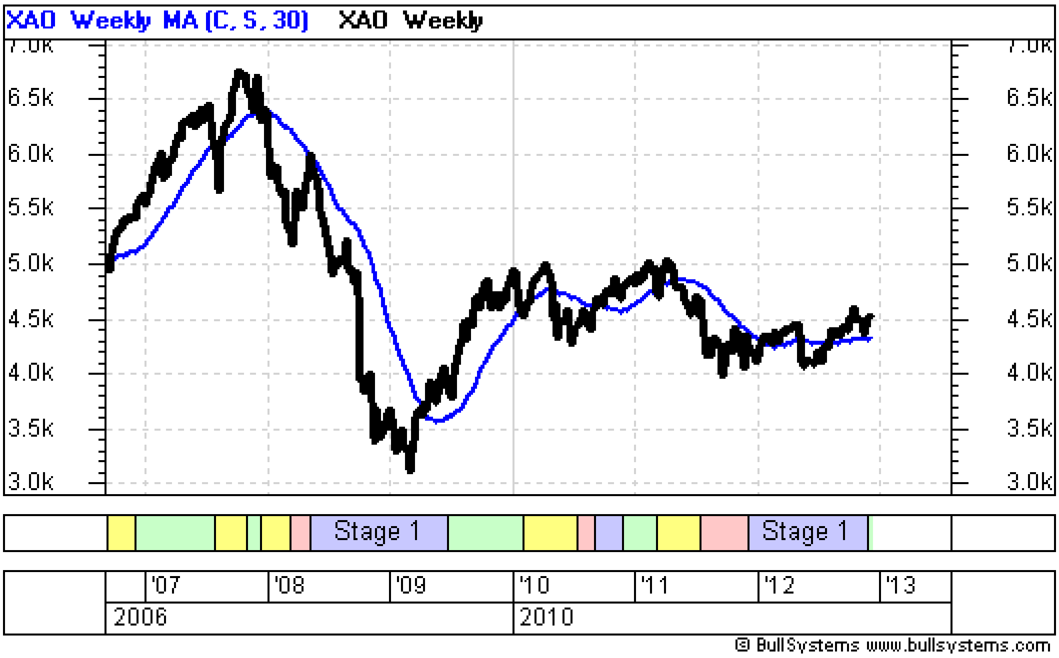
This also helps explain that "investors are not investors". And so the approach and strategies of the larger investors may not be relevant or appropriate for the smaller retail investors. The old-time buy-and-hold rule is relevant to some of the large investors because their fund rules might mandate how they invest, and they could have a lot of trouble quickly liquidating a very large position in any share.

"Time in the market" is a furphy. Some of the advisers, big boys and professionals often tout the old adage "stay invested for the long term", that "you can't time the market". Call it a furphy or a porky; it doesn't matter, because the retail investor can certainly "time the market". Many thousands of technical analysts around the world successfully do this all the time. Of course, it is easier in a raging bull market.

**Step 2 - Buy some good books**

If you have any doubts about the possibility of successfully "timing the market", then take a look at the great Australian book '*Exploding the Myths'*, by Frank Watkins. This is a must read for any new entrant to sharemarket investing, in which the author explodes some of the myths surrounding the market and points out the traps and pitfalls to which unwary newcomers can fall prey.

**All Ordinaries (XAO) weekly chart with 30-week Moving Average**

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*(larger versions of the charts available)*

**Step 3 - Embrace some key principles**

"The trend is your friend". This phrase sums up one underlying principle that is very useful for all sharemarket investors to understand. Studies have shown that it is statistically probable for an uptrending price to continue trending higher. And likewise, for a downtrending share price, it is probable it will continue trending lower. The only minor issue is to understand how to identify a rising trend, which is nothing more than a share price (visualised on a price chart) that shows a sequence of higher peaks and higher troughs.

"The stock is cheap, so let's buy more." Wrong! In the opinion of many technical analysts, this approach is lunacy. You can do all the valuation studies you like and come up with many different price valuations for a particular share, and your answer is likely to be different to that of many other people.

As for whose valuation is correct, at the end of the day the valuation for any share is the closing price on the market that day. And tomorrow's price could be different. We cannot argue with the market, because the market is always right.

Buying shares while the price is in a confirmed downtrend is not a good idea, because it is likely the downtrend will continue and the shares will get cheaper. How much do you want to see your capital depreciate? What if it is heading for liquidation? - a few companies do in every major market downturn (even blue-chips). So consider these strategies:

- **Cut losses early**. This is an approach many people find hard to do. If an investment decision turns out to have been a bad one, perhaps we should sell out and crystallise losses while they are small. If a downtrend gets under way, and it is likely to continue, then who knows where and when the downtrend will stop? By cutting losses while they are small, and letting our profits run, we can still be profitable with a win-to-loss ratio of just 40 per cent. That is, if we have enough good wins, and many little losses, the end result can still be a net profit.
- **Stop-loss**. If we have followed the logic set out above, it makes perfect sense to implement a stop-loss (a predetermined point at which you sell) approach. That is, at the time we open a new position in the

market, we should already have in mind a lower price level at which we will sell. And be clear about how quickly we will execute the sell order.

- **Money and risk management**. Some of the ideas discussed above fall into the category of sound money and risk management. Other possible strategies include the 'Two Per cent Rule', where we allow no more than 2 per cent of our total capital to be "at risk" in any one position. That is, if the investment value falls, then we liquidate before 2 per cent of our total capital is lost. Another similar strategy rule is to limit each investment position to no more than 20 per cent (for example) of the total investment capital. Having rules like this recorded in our strategy will limit the risks, and help us to sleep at night.
- **Write down the investment strategy**. It is one thing to have decided on the details of our approach, including our risk management rules; but it is another thing to have it all written down and on the desk when we need it, so that we can instantly refer to it and take action in a calm and controlled manner.

**Step 4 - View the price chart**

Having decided on some key principles to help invest sensibly and limit risk, it is quite easy to look at a price chart for a share, and confirm whether it is trending or not. Many charting tools enable us to easily apply technical analysis chart indicators, such as moving average. There are three main ways to access price charts: free web-based tools, online broker tools (such as with CommSec, eTrade, NabTrade, Westpac, BellDirect, DirectShares, and many more), and the charting software that can be installed on your computer.

Some of the free web-based charting tools include:

- ASX Chart
- Yahoo!7Finance
- Net quote
- StockCharts
- Big Charts
- Live Charts UK
- ADVFN

Some of these tools can chart shares and indexes across multiple countries and exchanges, in which case you may need to enter a code to identify the country or exchange.

Software packages are available for a range of prices with varying amounts of product support. They can be installed on your computer to give you greater power and flexibility. You might consider the following list (in no particular order, with absolutely no suggestions or recommendations provided):

- Incredible Charts
- BullCharts
- Ami Broker
- Pro Trader
- Bourse Data
- Guppytraders Essentials
- Ezy Chart
- MetaStock
- Market Analyst
- Ninja Trader

### Step 5 - Join a group

To make faster progress with mastering this subject, you could consider joining a group or association of like-minded people for face-to-face networking and ongoing education. For example:

- Australian Technical Analysts Association
- Australian Shareholders' Association
- Australian Investors Association

### About the author

Robert Brain is a sharemarket analyst and nimble short-term investor, and runs Brainy's Share Market Toolbox web-based business, supporting investors and traders. He is a national director of the Australian Technical Analysts Association (ATAA), and Vice-President of the Melbourne ATAA Chapter. The charts shown here are produced using the Australian BullCharts charting software, and Robert heads up the Australian BullCharts User Group.

### About the Australian Technical Analysts Association (ATAA)

The ATAA is a not-for-profit association of people who are interested in the application of technical analysis. Many members operate their own SMSF, some are private traders/investors and some are professionals in the financial services industry. The ATAA has nine Chapters in Australia, based in capital cities and some provincial centres. Visit the ATAA website for details.