Brainy's Articles on

Technical Analysis

Avoid paying too much

Introduction

Whenever we spot a rising share price, we can easily feel a sense of need — that we have to buy it so as not to miss out on the rising share price. The greater the price increase we are seeing, the greater the underlying feeling that we are missing out. This can result in an impulsive action to purchase the stock at any price. But, in many cases there is a price point above which we are chasing hot air.

The fundamental analyst would work through some calculations and some modelling and come up with a theoretical upper value for the stock; but at the end of the day, the only valuation that matters is what the market is prepared to pay on the day. But on some days the market can get way ahead of itself and push a share price unreasonably high. In this case we don't want to pay an unreasonably high price to own the stock.

The sample in Figure 1 at right is just one example of the price running away for no good reason. It shows a single week in July 2009 when a share price rose 400% from 2.5 cents to a high of 14.5 cents before closing down at 12.5 cents. Within days, the price was languishing in a range between 6 and 9 cents. It would have been a challenge to make a profit on this stock at that time.

Figure 1: In hindsight, even 8 cents was too much to pay.

So, how can we avoid paying too much for shares?

In this Article in Brainy's series on technical analysis, TA-5300, *"Avoid paying too much"*, we take a look at a couple of ways to beware of the the trap of paying too much for a stock. In this Article we will describe two ways to derive a *"Maximum Chase"* price level, beyond which we should be cautious about a purchase.

When to be careful!

It is easy to pay too much for a stock in a number of situations including:

- At a price breakout above horizontal resistance, where a new uptrend commences.
- At a price breakout above a chart pattern (triangle, pennant, wedge, etc.).
- When a new uptrend commences after a downtrend is confirmed to be finished.
- Once a trend is under way, it is possible to join the trend; but at an opportune point and not at a point of over-price.

Overview

Of all the possible methods to avoid paying too much, there are four that we will consider here:

- ***Percentage*** — Use a rough rule-of-thumb measure based on a percentage of the share price. This would be difficult to automate on a price chart; but can be worth calculating.
- ***CBL*** — Use the recent price range and pivot low swing points as shown on the price chart in candlesticks to set a *Maximum Chase* price level. This method uses the CBL chart tool that is available in some charting software packages.
- ***ATR Multiple*** — Determine a *Maximum Chase* level based on the recent Average True Range (ATR) of the share price. This method uses a chart indicator that can be easily applied to the price chart.
- ***Candlestick and chart patterns***.

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