

# Share Price Charts For Analysts

Few security analysts in Australia keep charts recording the behaviour of share prices, and still fewer would have a comprehensive range covering 250 larger companies. Why, if so much time is spent studying the history of a company, is not some time allocated to examining in detail the history of investors' expectations, via share price charts? After all, the security analyst's most important function is to arrive at a conclusion — should a stock be bought, sold or simply held by various types of investors, at a price. Should he not then show more interest in the stock market's appraisal of such a security?

Security analysts answer this question in different ways. Many claim that by watching turnovers and prices closely each day they can keep an adequate check on the technical position of all stocks in which they are interested. This amounts to mental charting and, although it may work some of the time on a short-term basis, it fails to reveal such phenomena as trends or price-volume relationships over any length of time. Some analysts claim that they have no spare time to keep charts; many express profound suspicion of chartists or simply reject charts as just another worthless system with no statistical justification.

A pure chartist or "technician" regards his charts as a panacea for all investor ailments, and they appear to offer two attractions in particular. First, charting is a technique of forecasting stock prices which does not require the user to worry about or understand any fundamental considerations at all. He does not concern himself with a company's financial structure or its possible earning power, nor is he interested in a company's business. All this is fully discounted by the share market, he would argue, and

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further, fundamental factors are normally history.

Second, by reading a few books and with practical application, one can inform himself intelligently on charts within a relatively short time and can proceed to make recommendations on a wide range of stocks. In contrast, the fundamentalist can feel confident about his market judgment only after some years of experience. Both these points tend to denigrate chartists in the eyes of the traditional school.

The well-known and very plausible assumption underpinning all charting theory is that most vital information about any stock, though as yet not announced, is nevertheless known and acted upon by a small group of investors, often employees or associates of the company concerned. Their action may influence the course of share prices and their enthusiasm will be reflected in the volume of shares traded. In practice the share market seldom reacts violently to news when it is officially announced. Thus the chartist can claim to be able to sense changes in a company's present trading position or in its potential earning power without having to qualify or evaluate them.

In contrast, the fundamentalist with his ear to the ground will be lucky to pick up this sort of information for more than a few companies. Certainly, he will rarely be told bad news by the management of a company; even if he is commendably energetic, he will often be left wondering what is happening between official announcements.

Chartists, therefore, mistrust predictions made from fundamental premises.

Thus, the two schools of thought have tended to stay mutually exclusive, with the chartists most reluctant to become contaminated by opinions which might influence their chart interpretations, and the fundamentalists satisfied to make their final investment decisions on the basis of yields, after careful evaluation of all available data.

Whether the price history of stocks or commodities is any guide at all to future price patterns has drawn a great deal of comment from statisticians since the turn of the century. It has been established that, if random numbers, generated by a suitably constructed roulette wheel, are charted for instance, patterns resembling some of the well-known charting configurations such as "head and shoulders", "triangles" and "rectangles" emerge and so also do trends. The statisticians have gone out of their way to unmask chart forecasting as being a fallacy.

This chartist's reaction to this sort of criticism is that he is not simply looking at price changes, but rather price action relative to volume. He would point out that where the trend of volume and price moved together this would be bullish, but where volume rose on a fall, or a price moved up without volume confirmation, this would most likely be a bad omen. He would claim that the added factor of volume gives a semblance of order to the otherwise random character of stock market prices.

In theory most chartists agree as to what formations they are looking for and as to what interpretation they would advance if confronted with such classical formations as an "ascending triangle", a "wedge" or a "pennant". Critics of charting

draw on this uniformity of theory when they suggest that, if chartists were numerous, charts would always work out as forecast because their masters would act according to their expectations until they had been fulfilled. This argument is plainly naive as chartists influence only a very small proportion of investors and, furthermore, chart patterns only rarely work out strictly according to the book. In reality, it is just as hard to get chartists to agree on charts as it is to have a general concurrence among fundamentalists on price earnings multiples or the likely trend of earnings.

Chartists are fond of saying what will happen if particular patterns form, but they never say why. For example, if a stock forms a "head and shoulders" top why should the minimum downside risk lie the same distance from the "neckline" as the neckline is to the top of the formation? Read any number of esoteric charting texts and you won't find out "why", only "how far". Why, in a point and figure chart, should the minimum downside projection from a well defined top be equal to the lateral measurement of that top? The chartist cannot explain this—it usually works, he says, and that is what counts.

A second general shortcoming of

chartists is their failure to recognise the limitations of charts. If something cannot be known, such as whether an oil well will be a producer, or whether an institution might dump a large parcel on the market, the share market cannot anticipate the outcome. Chartists in the past have been far too willing to make projections whenever familiar formations occur and equally willing to make price predictions about stocks which cannot be discounted accurately for particular types of uncertainties. The accuracy of a chartist's projections is normally distorted by his rejoicing over the ones that work and his not mentioning those which fail. Projections of share prices are the most questionable aspect of charting but this does not mean that charts should be discarded; far from it.

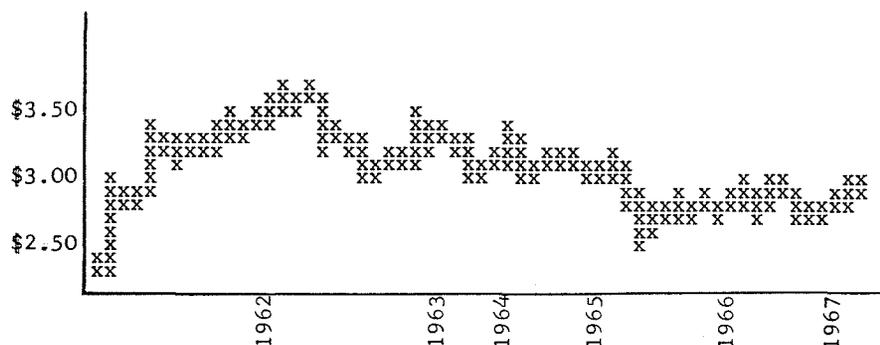
Charts are an invaluable guide to the analyst in pointing to areas of price support and resistance and in quantifying them approximately. The simple theory of support and resistance is as follows. Investors as a whole, individuals and institutions alike, share a common failing. If they buy a stock and then see it rise significantly they make a mental note to buy more if it should return to near that price; this will then represent support. Conversely, if they

purchase a stock and watch the price fall away, rather than take a salutary loss, they prefer to wait—for several years if necessary—in the hope that they will recoup the initial outlay; this represents resistance.

Whether or not the theory fits the average investor, it can be seen to work surprisingly well in most stocks most of the time. It is amazing just how long the man in the street can remember the exact price at which he bought a stock and where he eventually sold out; investors have long memories. By using charts, then, an analyst can see what technical resistance exists above the current price and where it is likely to be encountered; he will also be able to gauge how far a stock might fall before it runs into strong support. A security analyst would be foolish to make short-term bullish predictions about a stock on fundamental grounds, if there was a strong resistance area only two brokerages above the current price, particularly if it had taken two or three years to form.

A second major contribution of charts is to show the trend of share prices. It could be argued that share prices move along trend lines, sometimes over long periods because fundamental factors are only gradually recognised by investors and, therefore, discounted by degrees, e.g., in the case of Western Mining. This is a moot point but, nevertheless, an inspection of a wide range of charts would reveal the existence of well defined trend lines for many stocks. A break in an uptrend or a downtrend in itself does not justify market action provided volume remains favourable but may be preliminary to the formation of a base or top, themselves necessary preludes to a change in trend. In Australia, major tops normally form over a period of not less than three months and can take over a year, but bases generally are more protracted than tops. In other words

*(Continued inside back cover)*



Note: Plotted to April, 1967

**Point and figure chart on Australian Consolidated Industries**

**(When the price had broken below \$3 early in 1965, all the trading since 1962 became a resistance barrier which has repeatedly prevented advances beyond \$3)**

## SHARE PRICE CHARTS – from page 8

share prices only very rarely break out of a rising trend and immediately initiate a falling trend; a period of sideways movement almost always occurs. That such an area of trading is forming does not necessarily point to an impending reversal of trend—it could well be the beginning of a neutral period of trading prior to a resumption of the up-trend. Thus an element of caution is called for in simply following trends.

As a general rule security analysts should avoid bullish recommendations on stocks in a down-trend as the extent is never precisely known, and a base may form over eighteen months and often longer, even perhaps five years, before a favourable trend emerges. While up-trends are pleasing to investors concerned, they do not continue forever and tops often occur much more quickly than bases. The cynic would liken following trends to studying past examination papers.

However, candidates are usually well advised to look at past papers.

The analyst should be particularly concerned with stocks which begin to look interesting on charts, such as where a large base has formed and where the current price is now above most of the base trading. Increased volume would enhance the technical position. Almost all marked changes in sentiment as shown on a chart occur through a changing fundamental situation, admixed, of course, with emotion and other investor irrationality. The analyst should then take the tip from his chart that something has probably changed and try to find out what that development might be. It will require considerable salesmanship to persuade an investor to buy a stock because the chart has said the price is going up.

In short, charts help the analyst to do his work more economically in that he is not looking at stocks

which appear unlikely to move significantly in either direction for some time. Rather, he is concentrating his researches on shares with short-term promise of recovery, enjoying a strong technical position, or conversely, on those stocks which appear vulnerable and show a weak technical situation. There are two principal dangers of using charts hand in hand with fundamental theory. There is sometimes a temptation for the analyst to see in charts what he wants to believe as a result of his fundamental researches. Charts are of value only where the analyst is sufficiently disciplined to be completely honest with himself. The second danger is that the fundamentalist will allow charts to stifle his thinking. It should always be remembered that charts are a lag indicator and are no better at picking the bottom or top of a market than any other system. Charts are a facet of security analysis, not a substitute but an integral part.

## A THEORY OF FINANCE FOR THE GROWTH COMPANY – from page 6

has met the ultimate test, as the market price of its ordinary shares increased by more than four times from the 1962 low to the 1966 high.<sup>14</sup>

Over the years consistent dividend increases, based upon increased earning power, can boost dividends to a remarkable level. A \$1,000 investment in International Business Machines ordinary shares in the early 1920s would now yield **annual** cash dividends of approximately \$10,000.

### Summary

Management must formulate its policies primarily for the benefit of its ordinary shareholders who are the real owners of any company.

Ordinary shareholders can make substantially higher returns on

their investment through capital gains than through cash dividends.

Capital gains are not achieved by accident, but by use of financial policies deliberately developed and implemented to increase the market value of the ordinary shares. These policies are designed to maximize net profit, concentrate this profit on a small number of ordinary shares, increase future earnings per share and cause investors to appraise present earnings liberally in valuing shares.

### FOOTNOTES

1. From the 1938 Annual Report of National Investors Corporation, an American investment trust. This represents one of the earliest recognitions of, and attempts to identify, growth companies.
2. "Those Delicious 'Growth Stocks'", *Fortune*, April, 1959, p.130.
3. Bernstein, P. F., "Growth Companies v. Growth Stocks," *Harvard Business Review*, September-October, 1956, p.91.
4. Bing, R. A., "Can We Improve Methods of Appraising Growth Stocks," *Commercial and Financial Chronical*, September 13, 1956, p.s.
5. 4th ed., McGraw-Hill, New York, 1961, p.428.
6. The MacMillan Company, New York.
7. Fisher, L. and Lorie, J. H., "Rates of Return on Investments in Common Stocks," *The Journal of Business*, January, 1964.
8. Source: Data from *Moody's Industrial Manual*, Moody's Investors Service Inc., New York, 1966.
9. "When the Crowd Goes One Way, Litton Goes the Other," *Fortune*, May, 1963, p.115.
10. Source: Data from *Monthly Stock Digest*, Data Digests Inc., New York, February, 1967.
11. "The Great Boom in Life Insurance Stocks," *Forbes*, April 15, 1964, p.21.
12. *How Fortunes Are Built With Life Insurance Stocks*, Best Books Inc., Santa Barbara, Cal., 1962.
13. Source: Data from *Moody's Handbook of Widely Held Common Stocks*, Moody's Investors Service Inc., New York, May, 1965; *Stock Guide*, Standard and Poors Corporation, New York, April, 1966; Corser, Henderson and Hale, Sharebrokers, Brisbane.
14. Source: Data from *Stock Guide*, Standard and Poors Corporation, New York, January, 1967.
15. Source: Data from *Moody's Industrial Manual*, Moody's Investors Service Inc., New York, 1966.