CONFESSIONS OF A CHARTIST

SHOULD WE HAVE SEEN THE CRASH COMING?

by RUSSELL LANDER

The precursors of the October crash might have been lurking in the complex geometry of the chartists — those sorcerers of the market who practice mathematical magic.

The editor has generously invited me to write an article discussing the efficacy of charting as an aid to investment decision-making. My eligibility for such a task would rest more with the fact that I have been a keen chart-watcher these past 25 years than on the spellbinding success of my recommendations flowing therefrom.

In the paragraphs which follow we shall look at the *raison d'etre* for charting, now known by the more dignified name of "technical analysis." We shall also examine the usefulness of popular charting notions, and the effectiveness of some of the widely used mathematical derivatives from market data, and look for clues in the charts which might have presaged the memorable events of October 1987.

The question of whether charts have a place in investment decision-making has been the substance of many academic papers. These usually write chartists off as misguided souls who hold out the forlorn hope that past data can be used to predict the future.

Twenty years ago in Australia, and presumably elsewhere, investment analysts tended to be polarised in either the fundamental or technical school. With charts now more freely available, replete with mathematical derivatives through computers, there has been a softening of the lines of demarcation.

Most fundamental analysts, while not willing to admit to making investment decisions on the basis of charts, are nevertheless keen to "see what the chart says." Few brokers' stock or market reports fail to comment on the technical position.

Some chartists have managed to maintain their purity, i.e. to avoid taking into account information other than market data about price and volume. Many, however, take the view, as does the writer, that technical analysis has a place in the investment decision-making process, as does fundamental analysis in all its colours.

That a broad rapprochment has taken place is clear from the following outline from a draft constitution of the International Federation of Technical Analysts Inc., which may well now have been confirmed by its members. IFTA is a US-based association which has affiliates in many other countries but not yet in Australia (for want of an energetic group of people to set up a local association). Under the heading "Principles and Policy," the IFTA draft puts the case for technical analysis succinctly as follows:

"The Federation asserts that the technical analysis of stock price movement and of the supply-demand relationships underlying them can make a vital contribution to the process of decision-making involved in efforts to preserve and enhance the investor's capital.

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tion on a number of grounds, including the following considerations: Technical Analysis deals directly with the generally undisputed fact that the market price of a stock, commodity, currency, etc. does not necessarily — nor indeed, usually — at any given time coincide with its intrinsic value, which itself is often a matter of controversy. In dealing with this frequently very elastic differential between market price and underlying value, technical analysis and fundamental analysis, insofar as they relate to specific common stocks, commodities, currencies, etc. and to all stock markets the world over, should properly be regarded as mutually complementary and, in fact, interdependent.

"In a broader prespective, technical analysis concerns itself also with supply-demand relationships affecting the equity, commodities, currency, etc. markets as a whole and with potential future shifts in these relationships that may be instrumental in shaping future price movements. In pursuit of this concern, it extends to the examination of money flows, banking statistics, interest rates, etc., past, present, and potentially future. It is in this area that technical analysis borders most closely on economics and fundamental security analysis, because money flows tend to impinge on stock, commodities, currency, etc. prices as well as on corporate earnings, and because the trend of interest rates tends to influence the market valuation of current and prospective earnings and dividends.

"Moreover, the tendency of price trends to persist and the investors' behavioural patterns to recur enables the technical analyst to recognize and anticipate potentially favourable or unfavourable investment environments. Indeed, the recognition of extremes in investor psychology is one of the technical market analyst's unique contributions to the field of investment techniques. The Federation asserts, in sum, that the technical analysis of stocks, commodities, etc. price movements and of the supply-demand relationships underlying them is a valid, indeed an indispensable, element in the formulation of a 'reasonable basis' for investment decisions."

My problem with support is that it is usually not forthcoming when it is most needed.

Support and resistance and price/volume relationships are held by some technicians to be central to the interpretation of charts. Support is established, it is held, when a stock, commodity or index climbs out of a sideways pattern. Those who bought in before the breakout would now like to have bought more and vow to increase their stake on any return to the old level. Those who sold before the breakout are sorry, even embarassed, and will correct the mistake, given a chance. Resistance, on the other hand, is built up where stock falls below a sideways pattern. Those who bought during this period, or who should have sold, will remember their entry or potential sale price and will vow to sell if ever the price revisits this critical level.

My problem with support is that it is usually not forthcoming when it is most needed, such as in a heavy fall in the market. By the same token, resistance zones cannot be relied upon to produce stock in volume at a given price. In a firm market, overhead resistance can be as fickle as support at the other end of the scale.

Price/volume relationships are another element of classical charting theory which does not measure up in practice in Australia. It is said that falling prices are not a cause for concern if accompanied by light volume. Traditional Australian bear markets of the likes of 1974 and 1981 were low-volume affairs which would have no given consolation to those who held on because activity was light.

Charting is an art form, not a science, and so flair and luck play a big part.

In my experience, the most useful characteristics in share, commodity or exchange-rate charts are trend, preferably drawn as a straight line or lines on semi-log paper, and patterns. The textbook trading patterns such as triangles, rectangles, pennants, head-and-shoulders and broadening formations are very useful in determining upside or downside potentials. Those who would claim that forecasts can be made from such patterns are overplaying their hands, as a true forecast is a price on a date. It is the time factor which charts are equivocal on.

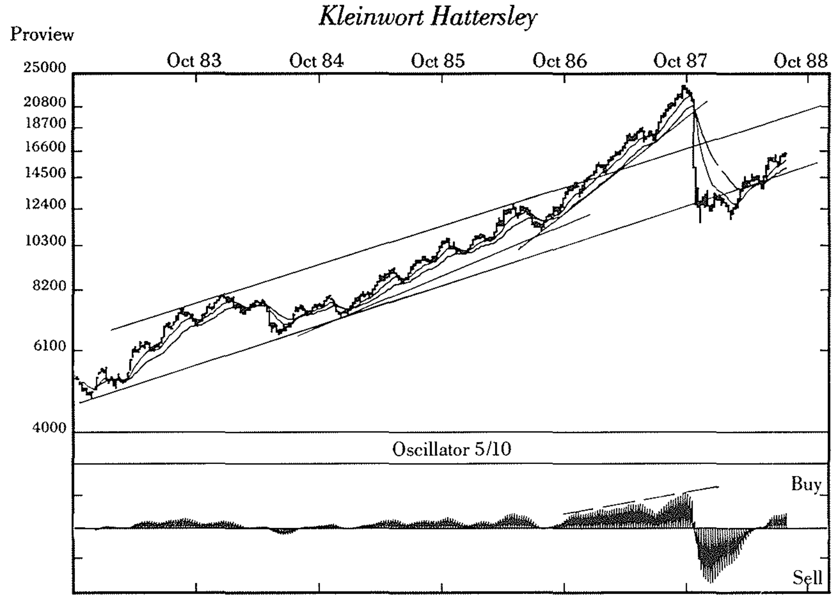
Yes, patterns can give an indication of the likely extent of a move but how long this will take remains hidden. Hypotheses about the timing of a move can be made from channelling but actual dates are the most vulnerable element of chart forecasts. It is not good enough to say that BHP can go to $12.00. This is a meaningless statement unless time parameters are introduced.

We live in an age when there is no limit to the mathematical refinements one can introduce to stock, commodity or exchange-rate charts.

Some systems work on occasions but no method works all the time. Coppock Indicators (ie, weighted momentum) brilliantly called the bottom of the Australian stock-market in September 1982. They were, however, found wanting in the October crash and its aftermath. Moving averages and moving average spreads often work well, but often suffer from heavy lags. Elliott Wave followers have victories from time to time, but there are big problems in knowing where you are at any given point. Somehow it's always easier counting backwards.

Charting is an art form, not a science, and so flair and luck play a big part. Nevertheless, having stated some of the limitations, let me say that charts are very useful in highlighting exceptional behaviour. They also show the character of a stock which reflects the nature of the company's business and the type of investor who follows it. Patterns give some idea of potential moves, while properly drawn trend channels provide a range within which a stock should be retained or eschewed by investors depending on their direction.

All Ordinaries Weekly till 22 July
Kleinwort Hattersley



Industrial Equity Weekly till 22 July
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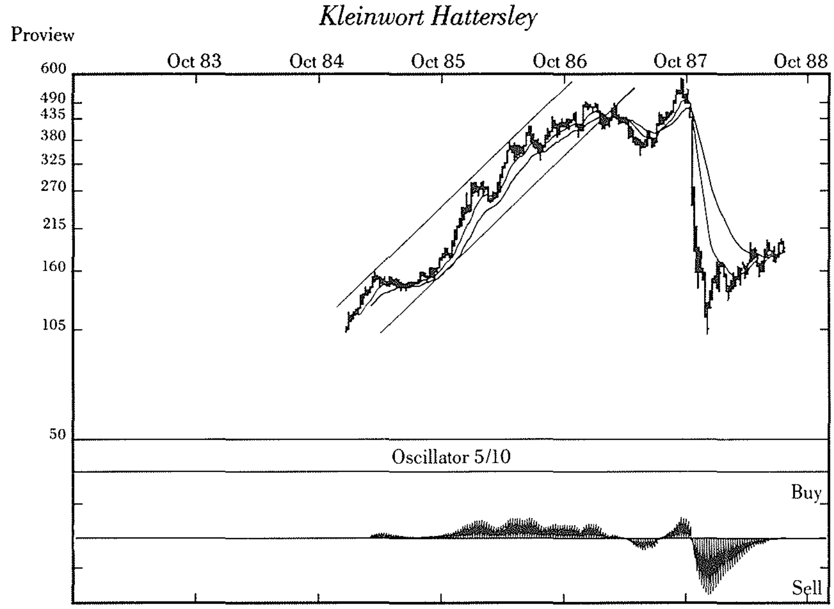

All seasoned stock-market observers knew last year that ultimately there would be a wipe-out, although few would have been thinking of a 50 per cent correction at a stroke.

New floats, many of poor quality, were flooding the market and boy wonders were springing up everywhere under the euphemism of "entrepreneurial investor." Price/earnings multiples were at the top end of their scale for the twentieth century and the commitment of the small investor was very heavy. I was looking for an indication of topping-out in primary trend breaks in a few stocks which could be the precursor of a groundswell of such trend-breaks across the whole market.

Unfortunately, virtually all the breaks occurred in Australia on one day, October 20, 1987. We were denied the luxury of bell-wethers. Looking back on the event, I can find only a few signals on the charts which were pointing to disaster and these were low-key. Firstly, some of the entrepreneurial investor stocks broke their primary trend channels in the first quarter of 1987, examples being Industrial Equity, The Adelaide Steamship Company Limited and Adriadne. Coincidentally, the New Zealand stockmarket, as measured by the Barclays Index, crashed through its primary uptrend.

These stocks, and in fact the New Zealand market as a whole, were being driven by once-off capital profits accounted for above-the-line and investors were happy to attach quite solid multiples to these earnings in pricing the shares. This was the most logical place for a crack to appear.

The problem was, however, that, after the initial trend-break, Adelaide Steamship and the New Zealand Barclays Index promptly returned to their previous peaks and IEL moved well into new high ground. This is illustrated by the accompanying Proview weekly chart with attendant moving averages (5 + 10 week). Sure, some individual stocks may have given sell signals as a result of the short-term moving averages' crossing longer-term lines. But there was no widespread occurrence of this and, at the time, it could have been seen as a temporary minor correction.

The only other warning sign was the very fact that stocks and indexes were running through the top of their trend channels; ie, they were showing exponential growth. This phenomenon is borne out by the Proview log chart on the All Ordinaries Index covering the period from the beginning of 1983 to July 28, 1988. The spread between the 5 and 10-week moving averages in fact widened markedly up to the time of the crash, which was a warning sign of excessive optimism. This tendency was also evident in a wide range of individual stock charts here and in other markets around the world.

If this article were to succeed only in drawing others out on the subject of possible precursors of the October crash, it would have been a worthwhile exercise. The closing note is, then, a question: Did you see the crash coming, and, if so, what was your guiding light? The editor would like to hear from you for the next issue.☐