Welcome to the last issue of the Chart Pattern Secrets Newsletter for this series.

We hope that you find it useful and are able to implement some of the ideas into your own trading methodology. Chart patterns can provide an interesting insight into potential price action and form an integral part of successful trading strategies.

Contents:

This issue contains the following:

Next Issue:

This now draws to a close this series of articles on chart patterns. We hope you have enjoyed receiving the newsletters. If there is any topic you would like us to further investigate, please inform us accordingly. We thank you for your interest.

Assumtions behind Technical Analysis

There are two main streams of thought when it comes to analysis of potential companies to purchase. They are fundamental and technical analysis. Fundamental analysis is heavily used by traditional stockbrokers and involves an assessment made on a company's operations.

Various factors and information will be considered in a fundamental assessment to include profit, outlook for the industry the company operates in, forecast profit, key personnel in senior appointments, the members of the board of directors, the main sources of revenue and whether they can be consistently relied upon in the future, plans for business growth to name a few.

Technical analysis is also widely used and is the most common tool used by private traders. The use of technical analysis and its effectiveness is based on a number of assumptions about the way the market operates. They are:

- the market price discounts everything that drives buyers and sellers
- human nature is constant, resulting in recurring behaviours in response to similar situations and thus generating repetition of certain price patterns
- prices are not entirely random and move in trends for significant periods of time

Often market participants are driven in their decision making by the information that is available to them, whether the information is publicly available or not.

Technical analysis assumes that all the factors that influence the price of a security have already been factored into the price. This is why technical analysts never concern themselves with why prices go up or down, and one of the reasons why often the price will be a leading indicator of published information.

Despite the passage of time, human nature and behaviour over the years, remains constant. All market participants are driven by similar emotions and will often react to situations in the same way. Moreover, there are always a continual flow of new participants into the market and they are generally ignorant of the way the market has behaved in the past. For this reason, the same mistakes are often repeated by each new group of market participants.

Technical analysts develop an understanding of the way crowds of people will react to certain situations, and are able to identify certain patterns in price charts. Therefore, they are able to form a view on the likely direction of the price of a security.

If prices did not move in trends, then there would be little use for technical analysis. The more efficient a market is, the less effective technical analysis is, as prices will be random and not move in trends. Markets are generally efficient, however often the information dispersion takes some time and therefore people react to that information over time increasing the chances of prices trending. Should the information be acted upon immediately, prices will be more random and technical analysis will almost be useless. This is rarely the case, however.

Why Break the Rules

There are a few trading rules that have stood the test of time and enable traders to trade profitably, yet a lot of people fail to follow them. The rules are no secret to anyone as you will find them in many trading books and other materials. The rules like 'cut your losses' and 'follow the trend' have worked for hundreds of years yet most people ignore them!

Money is something that affects people's emotions and your natural instincts with money will often encourage you to break some of the time tested risk management rules, for example 'cutting your losses' and 'keeping your trades small'. Most traders focus on making money and realising a loss goes against the aim of making money. Similarly, when you have a position that is performing strongly, a small part of you wants to sell that position to realise the profit. This is perfectly natural. Letting your profits run and not selling too early is also an important time tested rule, however because of the focus on money, some people can be very quick to sell shares when in a profitable situation.

If you find it difficult to accept an initial small percentage loss in a trade, what makes you think it is going to be easier later on to sell the shares when the position has lost 30% or more? Yet, when you consider the influence of trends in the market and how important it is that you manage risk, the best time to sell the shares is when you are faced with only a small loss.

Thoughts often appear about holding on to shares that are falling in value because one day in the future, they will increase in value and return to the price that you purchased them at. This is unfortunately a myth that many people have about shares in the market. Some people believe that shares will always return to previous values, presenting them an opportunity to sell them at break even. There is a chance that the share price will never return to the price you bought them at.

Furthermore, whilst you may have absolute confidence that a share price will return to levels that you purchased them at, consider if it is worth holding on to them and waiting for that time to come, if it does. Would it not be better to sell those shares and move on by committing your trading capital into a company whose share price is clearly trending up at the present time? Often people will think about how they will feel if they sell shares and in 12 months time, the share price returns to where they purchased them. There is a feeling of, 'I should have just held on to them'. Meanwhile however, over that 12 month period whilst you may have been waiting for the share price to return, your trading capital was elsewhere obtaining solid returns for you.

All of these emotions and others can paralyse you and force you into not making a decision. Remember the old adage that says that taking no action is an action. Successful trading is all about sound decision making and you need to ensure that some of these emotional impulses do not freeze you or cloud your judgement.

Comments / Feedback:

Any comments on the contents of this publication or suggestions for future publications will be warmly welcomed. Please email to cpfinder@tradingxl.com.au, fax to +61 3 9870 1738 or phone us on +61 3 8802 0593.

Disclaimer:

This publication is not, and should not be construed as an offer to sell or solicitation of an offer to purchase or subscribe for any investment. Any securities discussed in this publication are unsolicited general information only. Trading Excellence did not take into account the investment objectives, financial situation and particular needs of any particular person; and before making an investment decision on the basis of the information, the investor or prospective investor needs to consider, with or without the assistance of a securities adviser, whether the information is appropriate in light of the particular investment needs, objectives and financial circumstances of the investor or prospective investor.