The Futility of Technical Analysis

March 23, 2016
By: Direk Khanijou

This is a topic that has been on my mind for a while now and one that I feel strongly about.

Technical analysis is essentially the making and interpreting of stock charts. Its practitioners are called chartists or technicians. They study the past stock price movements and the volume of trading for a clue to the direction of future change. It is a popular form of equities selection for brokers, traders and speculators.

True, there can be momentum in stock prices due to crowd psychology but forecasting short run changes in stock prices is inherently unpredictable. Trying to predict what tomorrow's stock price will be by looking at today's stock price is as silly as forecasting tomorrow's weather by looking at today's weather. Even Warren Buffett flirted with technical analysis. He abandoned it after realizing that 'technical analysis didn't work when I turned the chart upside down and didn't get a different answer.'

Furthermore, a true chartist doesn't even care to know what business or industry a company is in, as long as he or she can study its stock chart. A chartist is by definition a trader/speculator, not a long-term investor. He buys when the auguries look good and sells on bad omens. His typical holding period is short – usually in minutes, hours and maybe days. He looks at stocks as little pieces of paper to be traded back and forth – not as equity in a business. The only thing he knows about his stocks are usually the ticker symbol and the stock price.

> *If you're an investor, you're looking on what the asset is going to do. If you're a speculator, you're commonly focusing on what the price of the object is going to do.*
>
> \- Warren Buffett

People's fascination with technical analysis and forecasting is not new. Humans have always had this craving to have someone tell them the future. Long ago, kings would hire people to read sheep guts. There's always been a market for people who pretend to know the future. Listening to today's forecasters is just as crazy as when the king hired the guy to look at the sheep guts.

Fred Schwed puts it brilliantly in *Where are the Customers' Yachts?*:

> *The appeal of TA is to the false instinct that we all seem to have that share prices are somehow predictable because they seem to follow physical laws.*
>
> *There are many kinds of chartists and charting methods; for example, some try to indemnify Fibonacci numbers in price movements. […] Another popular TA method is to look for patterns that repeat themselves; for example, a small peak, followed by a larger one, followed by a smaller one is called a 'head and shoulders' and is supposed to be followed by a large drop.*
>
> *Charting doesn't really work, or at least, not well enough to take money out of it. It's no good arguing with chartists – you can no more change their minds than you can that of a member of an extreme religious cult. If they lose a lot of money, which they often do, because charting encourages you to trade too often, they tend to explain it by saying that they didn't follow their own rules closely enough.*
>
> *Chartism doesn't work because, essentially, it is looking for patterns that aren't really there. The human brain, which evolved when we were struggling for existence in a hostile environment, is designed to look for patterns everywhere.*
>
> *Seeing patterns in little flickers of light, or sudden changes in temperature, might have been very useful in helping us to find things to eat, back in the Stone Age, but it doesn't help us predict the future of share prices today. This pattern-seeking quality leads to 'over-fitting' complex data into seemingly reliable patters that, a long time later, turn out not to have been the patterns we thought they were.*

To sum up, everyone is looking for the 'silver bullet' that will allow them to make money on a consistent basis without commensurate risk. However, successful investing can't be reduced to an algorithm and routinized. The reasons are simple. No rule works, the environment isn't controllable, and circumstances rarely repeat exactly.