Charting – Can it Predict the Future?

I have lost count of how often inexperienced investors, who are trying to learn the craft of investing, complain to me that even after quite extensive study of charting and technical analysis, they cannot get to the point where they can tell what is going to happen i.e. predict the future. They want to know how much longer will it take to reach that point?

I have found that some people never find the answers to questions like this for the simple reason that they are asking the wrong questions. Ask yourself how many times have you felt that there was a problem you needed to solve, but could not somehow come to grips with it? Mostly, when this happens it is not the solution that is elusive. It is the definition of the problem. If you can properly identify what your problem is, you are most of the way to solving it. Likewise, if you ask the wrong question, you will tend not get the answer to the question you should have asked.

The question this article began with falls into this category in my opinion. Let me assure anyone still asking it that they are not alone. It is a common misconception that technical analysis, or fundamental analysis for that matter, is about prediction. We would all like to know what the future holds and it is perfectly natural for most people to go through their entire life without realising that predicting the future is akin to Don Quixote tilting at windmills. I have studied a great deal of research and literature that suggests very strongly that it is very difficult for us to predict the future. If the system we are trying to predict is extremely simple, yes, it may be possible to get it right in the short term. However, as soon as the system becomes in any way complex, as is the case with a modern free enterprise economy, it is almost impossible to predict the outcome with any consistency. Moreover, the further ahead we try to predict something, the less chance we have of being consistently successful.

Does this also suggest that analysis is useless? No, not really. Benjamin Graham, the father of security analysis agreed with me that it was not possible to predict company stock market performance. His approach was to find companies that had been consistently successful in the past and which were cheap. This gave him a margin of error. Even if the company were to suffer considerable misfortune in the short term, the low price paid for it would act as a buffer against catastrophic loss.

This suggests that if we are looking for analysis to provide predictions, we are asking the wrong question of it. The correct questions we should ask of technical analysis are not about prediction, but about analysing a situation in order to better understand it and plan what action to take. Analysis questions will include: What is the condition of the market? What is the balance of supply and demand? Is there any evidence of a change in the balance? What are all the things that might happen, no matter how unlikely?

Charting and technical analysis is no more or less reliable than any other method in predicting the future – abysmal. The very real value of charting and technical analysis lies in being able to see what buyers and sellers are doing. We cannot see this with fundamental analysis, because it studies value. Charting and technical analysis studies price. Price is determined by the interaction of buyers and sellers. If buyers are stronger, prices rise. If sellers are stronger, prices fall.

So, what we should be looking for from charting and technical analysis is to assess how the past led to the present situation. This assessment is then the basis for developing a strategy that is appropriate for the present conditions. That means to take advantage of opportunities and to manage risks.

Thinking only in terms of prediction is a naïve and unsophisticated approach, doomed to failure and frustration. Successful investors graduate from that level to one where they learn to read the situation and develop investment strategy. In doing that, there are some basic guidelines:

1. Start with the long term and analyse down to the short term. This is a very powerful idea, even for short term traders. Trends exist in multiple time frames. Longer term trends have a powerful influence on shorter term trends within them. The key idea is that if you trade any time frame in the direction of the higher time frames, you have more chance of being in a strong trend. Short term trends that are counter to longer term trends tend to be much weaker.

2. Start your analysis of the chart in any time frame with the facts. You should first establish what information is on the chart that is not an opinion or a judgement, but a fact. Is there a trend? What direction is it in? Where are support and resistance levels in relation to the present price? And so on. In other words, you describe what you can see that is factual.

3. Then move into analysis. Analysis is when you reason from the facts to a conclusion about the balance of buyers and sellers and whether there is evidence of a change in that balance. It also involves assessing the level of risk. Is it high or low? From those assessments, you should form a view as to where any opportunities are that you might take advantage of and where there are risks that you need to manage.

4. Finally, move into developing strategies for taking advantage of the opportunities and protecting yourself from the possible risks. Are the opportunities good enough to chase? Is the risk worth taking? How much risk should you assume? What sorts of risk should you assume and what types of risk should you minimise?

This is the proper use of technical analysis. You have probably already got enough knowledge to do this. All you have to do is to start asking the correct questions.

Now, I started by saying that asking what was in the future was the wrong question. From there we discussed to real use of charts – to analyse the condition of the market. Having done that, the really important question was stated and answered. We cannot predict the future, but we can from our analysis see a number of things that **might** happen, both opportunities and risks. Only one of them may happen, or a risk may be something out of left field. The right question to ask is: for each of the things that might happen and even those we think are highly unlikely to happen, we should ask the key question – what will we do if they were to happen? This is the right question. If we do our analysis and ask this question for each possible happening and have answered it, then we will be far ahead of the vast majority of investors.

When it comes to risk management, I do this kind of contingency thinking all the time. In the mid 1980's I asked what would be the biggest one day fall that might happen in the stock market. Then I looked at the worst day ever on Wall Street and doubled it. Then I mentally rehearsed what I would if it ever happened. It did happen in October 1987 and I calmly put my contingency plan into effect. There was no need to panic. I knew what I had planned to do and just carried it out.

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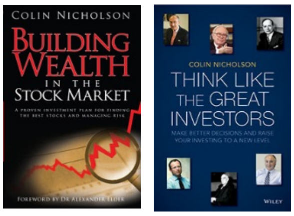

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