Why Technical Analysis Is NOT the Holy Grail of Investing

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The following is adapted from Navigate the Investment Jungle.

Technical analysis has taken on an almost magical quality in the investing world. In an unpredictable, volatile market, technical analysis offers comfort—a crystal ball to predict the future.

But like most fortune tellers, technical analysis is far from infallible. At best, it offers an incomplete view of a stock's health, and at worst, it can trick you into making harmful decisions for your portfolio.

While technical analysis can be a valuable component of your investing strategy, it is far from the holy grail of investing. If you want the best performance out of your portfolio, you can't rely on technical analysis alone. To cement this point, let's take a look at what happens when technical analysis is the only tool you use and why it's not enough.

Variable Results: An All-Too-Common Story of Technical Analysis

For six years, I hosted a weekly radio show about investment and finance. One day, I received an email from a gentleman who is well-known in the technical world. We'll call him Barney.

Barney confessed that he followed my show avidly, and he asked for some confidential advice. He explained that he picked his stocks predominantly using technical analysis, a method he had assumed would be consistently successful. To his surprise, he was getting variable results, sometimes good, sometimes poor.

He used several complicated analytical tools to track stock prices over time and make educated predictions. One of his top strategies was *candlestick analysis*. He would track the range in which a stock usually traded. If a stock broke out of that range on the upside, it could indicate that it was likely to continue rising, and if it dropped below that range on the downside, that might mean it was liable to fall further. He used this information to try to buy and sell at the ideal moment.

He made some good trades with this strategy, but also some very bad trades. By the time he reached out to me, he was losing confidence in his approach. He didn't understand why he wasn't seeing the returns his technical analysis indicated he should be getting.

This is what I see happen all too often with an overreliance on technical analysis. On paper, an investor's technical analysis says something should happen, but it simply doesn't translate to reality. The result is variable, inconsistent returns.

The Problem with Technical Analysis: An Inefficient Market

What's happening here? Why doesn't technical analysis always work?

Technical analysis is completed based on stock prices. It thus relies on an assumption that the market is efficient. Market efficiency means that all relevant information is already priced into stocks, or said another way, it means that the price of a stock reflects its true value.

It would be wonderful to believe that the market is transparent and that any amateur investor can interpret publicly available information to understand the true state of the market. Unfortunately, that's not the case. The market is *not* efficient.

If the market were truly efficient, it would mean that every single day, every stock trading on the exchange would be priced at a fair value. Clearly, this isn't the case.

Some stocks are overpriced while others are underpriced. Some rise based on nothing more concrete than enthusiasm and confidence—the dot-com boom was a perfect example of this—while others fall due to speculation or alarm.

Because we cannot rely on the price of a stock accurately reflecting its true value, we cannot rely completely on technical analysis.

Use All the Tools Available to You

Let's say you want to buy a product online that has been reviewed by previous customers. There's a star rating system as well as more detailed written reviews from customers. Before you buy the product, you will most likely look at the star rating and also read the top reviews.

You need to do the same with your investing. Technical analysis can be useful, but it only shows you part of the picture. You need to pair it with fundamental analysis.

While technical analysis tracks complex patterns, fundamental analysis concentrates on the basic financial health of a company, including earnings per share, valuations, and balance sheets. Companies that are making money are growing; those that aren't are in trouble. Technical analysis doesn't always reflect this reality, which is where fundamental analysis comes in.

By adding fundamental analysis to his technical expertise, Barney could have saved himself a lot of frustration and confusion, and so can you. Technical analysis is not the holy grail; it's simply one tool in your toolbox. To get the most out of your portfolio, use all the tools available to you.

For more advice on investing strategies, you can find Navigate the Investment Jungle on Amazon.

Douglas Stone is a wealth advisor with SeaCrest Wealth Management, who brings twenty-three years of experience to his work with affluent households. Douglas began questioning his industry's approach seven years into his career, and in 2009, he left the major wirehouse where he worked to become an independent advisor. For six years, he discussed his self-taught, holistic approach to wealth management on Real Money with Doug Stone, a radio program on KMED 1440 AM in Medford, Oregon. Today, Doug shares his knowledge and expertise through workshops, seminars, and speaking engagements.