

TECHNICAL ANALYSIS

**UNDERSTANDING STOCK CHARTS
& MOMENTUM INDICATORS
TO MAXIMIZE YOUR RETURNS**



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Introduction:

Technical analysis of stocks is both an art and a science. It is officially defined as an analysis method that uses past share prices and volume to forecast the direction of future prices. At first glance, technical analysis appears to be very complex with its own language, definitions, and methodologies. It can almost look like an ancient form of alchemy, super charged by software!

While technical analysis certainly can become complicated by some of the more esoteric methods, at its core, it's very simple.

This special report will explain technical analysis in easy to understand language so that you can immediately apply this forecasting methodology to improve your stock investing.

After reading this quick report, you will have actionable knowledge of stock charts and several of the hottest momentum indicators to maximize your ROI.

Chapter 1: The 3 Basic Principles Of Technical Analysis

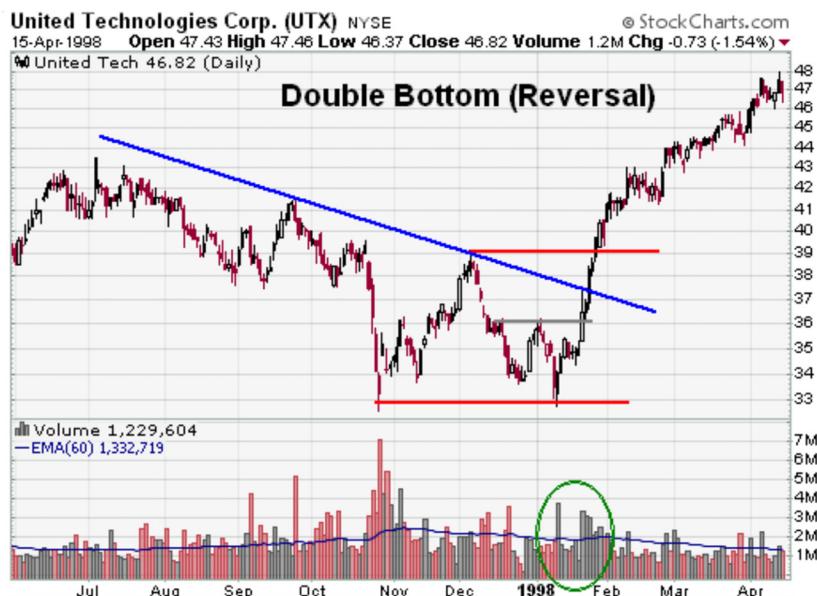
Principle One: History Repeats Itself

Technical analysts believe that history repeats itself again and again in the stock market. This is why they look for patterns like the following:

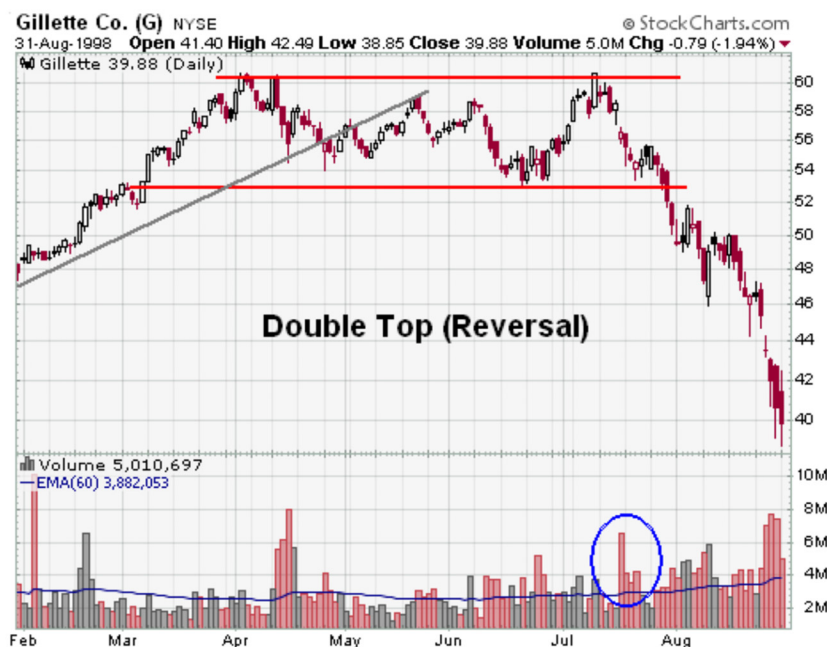
Head and Shoulders:



Double Bottom:



Double Top



Technical analysts believe that dozens of patterns such as these repeat time and time gain in the stock market. This means if you can identify one of these patterns forming, you can make a very good educated guess on where price is going to go next.

This idea is based on the belief that investor behavior never changes. The unchanging buying and selling behavior is what forms the chart price patterns therefore by knowing the patterns high probability trades can be made.

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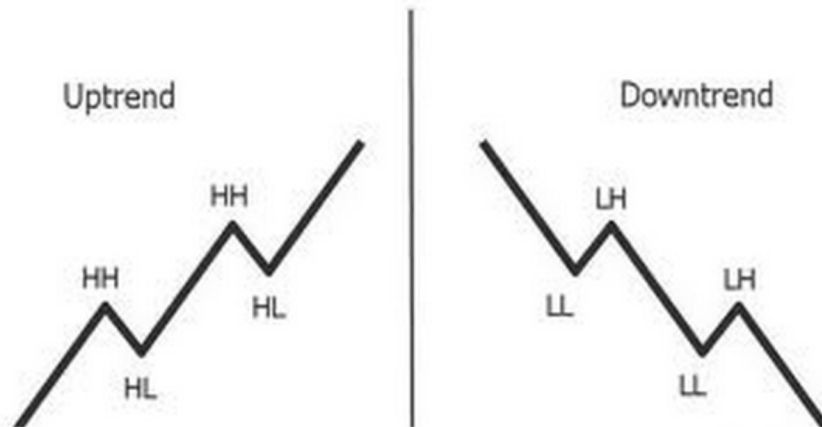
Principle 2: Price Is All That Matters

This really is the key concept behind all of tradition technical analysis. The belief is that all relevant information is already inherent in price and volume. All known and unknown fundamentals, news, and relevant economic information are already baked into the price/volume. Therefore, all one needs to do is study the charts themselves, as the other subjects do nothing but obscure the truth of price.

Principle 3: Price Trends

A price trend is a directional movement in prices across time. On the daily chart, two or more up days could be considered a trend. The same thing can be said for two or more down days on the daily chart.

The specific definition of an uptrend is a series of higher highs and higher lows. Whereas, the definition of a downtrend is a series of lower highs and lower lows on the price chart.



Identifying the next trend is the key to success as a technical analyst trader. Once a trend is identified, technical analysts believe that price will continue in the same direction long enough for profits. The holy grail of technical analysis is finding when trends will end and reverse. It is by trading at these reversal points that maximum profits can be extracted from the market.

Chapter 2: The Basic Tools Of Technical Analysis

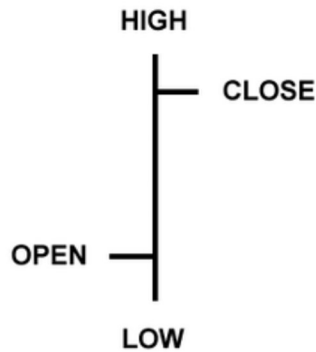
1. The Stock Chart

The most basic tool of technical analysis is the price chart. A price chart is a sequence of prices plotted on a graph. The graph's horizontal axis represents time and the vertical axis represents price.

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2. Price Plots

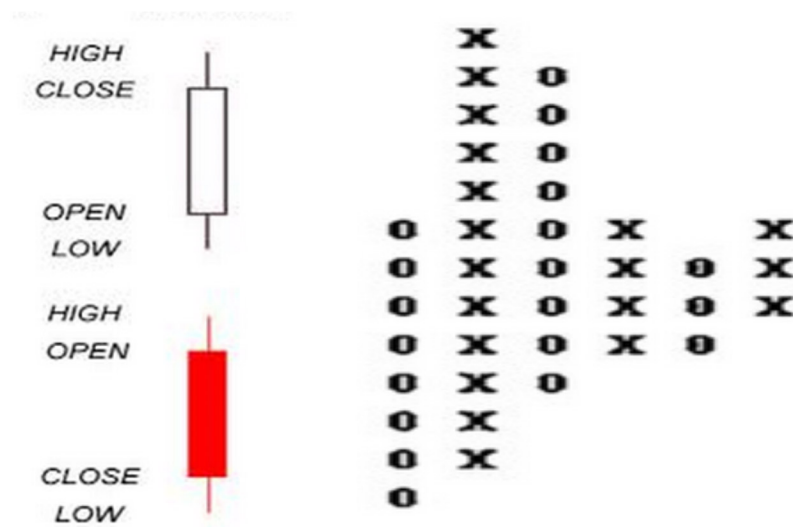
Price can be represented on the stock chart as a continuous line. However, most technical analysts use price bars to represent a variety of time frames. For example, the high, low of each day can be turned into a vertical price bar to plot the day's price movement on the daily chart. Remember, a price bar can represent any time frame. The most popular are weekly, daily, hourly, 15 minute, 5 minute, 1 minute bars for time frames. This is what a typical price bar looks like:



Price can also be illustrated as candlesticks on standard price charts and as X & O's on point and figure charts. Some traders believe that deeper insight can be derived from price by using these different ways of representing it. Here's what a candlestick and point & figure price plots look like:

Candle Sticks

Point & Figure



There are pluses and minus to every way to plot prices on a stock chart. My suggestion is to use what you are most comfortable with. Just remember my number one rule when it comes to technical analysis and trading in general:

SIMPLE IS BETTER

3. Technical Indicators

I know technical indicators may sound complicated. While indicators can become complicated, the basic idea and basic use of indicators is extremely simple. Indicators are used to better understand and determine price trend, as well as, likely changes in price trend.

The formal definition of a technical indicator is a series of data points that are derived by applying a mathematical formula to price data. In other words, indicators are the result of using math to crunch price data.

Indicators are used in multiple ways by technical analysts. The two primary ways are to **smooth price data** to **measure price momentum**. Let's drill down into each of these types of indicators.

Chapter 3: The Two Primary Types Of Indicators

A. Price Smoothing Indicators

These are the simplest and often the most powerful indicators. The simplest of these is called the **Simple Moving Average** or SMA. A Simple Moving Average calculates the average price of a stock over a specific number of periods.

The most popular periods are 20, 50, and 200. These periods can be monthly, weekly, daily, hourly, 15 minutes, 5 minutes and 1 minute in duration. The longer the time period the more significant the SMA is thought to be. Institutions and big money players generally only focus on the 200 day SMA, making it the most important SMA time frame for investors to watch. The practical idea behind a moving average is that it smooths data and makes it easier to define a trend.

Here's an example of both the 50 and 200 day Simple Moving Average. You can see how a SMA filters out the noise and provides a clear view of what is happening with trend. Not to mention, provides technical support for the price trend. You will notice that price often bounces in the opposite direction once it hits a major SMA.



B. Leading Indicators

While price smoothing indicators, such as Simple Moving Averages lag price, leading/momentum indicators are believed to lead price. In other words, the indicator signals price movements prior to their occurrence.

First, let's cover a few definitions and then we will look at how to use leading/momentum indicators.

Momentum measures the rate of change of a stock's price. The faster the price changes, the greater the price momentum. As momentum declines, price generally drops. The opposite is also true, increasing momentum usually goes hand in hand with rising prices.

One of the most popular and my favorite momentum indicators is called the **Relative Strength Index** or RSI.

Chapter 4: What Is The RSI and How To Use It

The Relative Strength Index or RSI compares the average price change of the advancing periods with the average change of the falling periods.

RSI is an oscillating indicator first popularized by Welles Wilder in his 1978 book, "New Concepts In Technical Trading Systems. The standard time period used by most technical analysts is fourteen.

The time frame is scaled on a chart from 0 to 100. Readings below 30 are believed to indicate an oversold condition; those above 70 are thought to indicate an overbought condition.

Oversold reflects that the selling appears finished therefore the stock is near its lows thus ready to push higher. Overbought means the buying appears finished therefore the stock is ready to drop from its highs. Here's the basic formula to calculate RSI:

$$RSI = 100 - \frac{100}{1 + RS}$$
$$RS = \text{Average Gain} / \text{Average Loss}$$

This is how RSI looks on stock price chart. As you can see, when price pierced the upper line at 70, it soon started its decent. In addition, when price touched or pierced the lower line at 30, a bounce would occur soon thereafter.



Remember, the RSI and other momentum indicators do not work all the time. They work best when price is moving sideways within a channel.

In strong uptrends and strong downtrends, the RSI can remain in oversold or overbought territory for long periods of time prior to the price trend changing.

Some technical analysts like to change the number of periods used to calculate the RSI. I have seen various studies that indicate that two periods is the ideal number. Fortunately, it's easy to change the formula in most common technical analysis software programs.

Chapter 5: Putting It All Together

I use a variety of timeframes and indicators to scan the markets for potential buy or sell candidates. Once my technical analysis scan locates several companies, I then drill down into the fundamentals to see if the fundamentals support the bearish or bullish technical picture. If they do, I look to trade in the direction both the technicals and fundamentals are confirming. If there is divergence, I may avoid the stock all together or wait for further confirmation before I make a trading decision.

Now you should have a basic working knowledge about what technical analysis is and how to use it help make trading decisions. Technical analysis can be turned into a very complicated topic. However, I have found over the last 25 years that the simple methods and tactics work the best in the stock market