

Identification through technical analysis: A study of charting and UK non-professional investors

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Abstract

The usefulness of technical analysis, or charting, has been questioned because it flies in the face of the ‘random walk’ and tests present conflicting results. We examine chartists’ decision-making techniques and derive a taxonomy of charting strategies based on investors’ market ontologies and calculative strategies. This distinguishes between trend-seekers and pattern-seekers, and trading as a system or an art. We argue that interpretative activity plays a more important role than previously thought and suggest that charting’s main appeal for users lies in its power as a heuristic device regardless of its effectiveness at generating returns.

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Introduction

Only days after landing in my new job I’ve found myself praising such statements from investors as: ‘I was looking at the 10-day moving average last night and it is a perfect reverse duck tail and pheasant. Let’s bet the ranch.’ At this juncture my role was only to shout encouragement: ‘Yeah! Let’s do it.’ (Lewis, 1989, p. 192)

In his entertaining account of life as a Salomon Brothers bond salesman, Michael Lewis finds himself bewildered by the investment practice of technical analysis, commonly known as ‘charting’. This is a method of identifying investment opportunities using graphs. Unlike fundamental analysis, charting

requires no information other than price history; it is not necessary to know the activity – nor even the name – of the company whose shares are traded; nor the precise nature of the financial instrument in question; nor the uses and likely demand for a given commodity. Chartists are not necessarily schooled in the staples of fundamental analysis: economics, accounting, industry expertise and financial modelling. Instead, they use methods of varying complexity to extrapolate past price movements into future predictions. Many researchers share Lewis’ bewilderment when encountering charting; for finance researchers especially it flies in the face of the ‘random walk’ of stock movements and the theory of efficient markets (Malkiel, 2003). Moreover, it ignores the commonsense understanding that security prices should reflect the value of the underlying asset (Preda, 2007b).

Despite this there is considerable evidence, offered mainly by finance researchers but also by

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sociologists, that charting is a popular strategy, even among professional traders (Menkhoff, 1997; Taylor & Allen, 1992; Zaloom, 2003). The employment of its own language, as highlighted in the opening quote, separates charting from other types of analysis, providing status and legitimacy and identifying proponents as experts (Batchelor & Ramyar, 2006; Lo et al., 2000). However, although there are numerous textbook summaries of charting methods (Batchelor & Ramyar, 2006), there is a striking absence of evidence on the way that charting is used ‘in the wild’, and thus little discussion of the calculative strategies and behaviour of individual chartists. This study proposes a conceptualisation of chartists through an inductive examination of how investors who use charting make investment decisions, the techniques that they use, and the way in which they make sense of the markets.

We focus on non-professional (non-salaried) investors for several reasons. They are relatively under researched. They are free from the hierarchical controls that affect professional traders and from the networks built up between them, proximate or otherwise (Buenza & Stark, 2004; Knorr Cetina & Bruegger, 2000; Knorr Cetina & Bruegger, 2002; Zaloom, 2006), because they are investing their own funds and often from their own homes. The result is that the observed decision-making process is less encumbered by exogenous factors. Moreover, recent studies have questioned the behaviour of non-professional (individual) investors, arguing that they are less sophisticated in comparison to professionals and that they process information differently (Allee et al., 2007; Frederickson & Miller, 2004). It is suggested that, where individual investors are less-informed, they will be over-confident in their knowledge and trade too aggressively (Bloomfield et al., 1999). Following Mayall (2006) we define non-professional investors as individuals investing their own money in the stocks of companies through the financial markets; while some may depend on this for their livelihood, the force of ‘non-professional’ is to distinguish between these and those salaried investors employed by financial organisations.

This article contributes to the growing Social Studies of Finance (SSF) research paradigm. It presents empirical evidence on the activities of non-professional investors that provides a valuable insight into their behaviour. A taxonomy is presented that identifies four types of charting strategy based on the market ontology of individual investors and their calculative autonomy. The taxonomy

highlights a differing understanding of how the market is structured (ordered or otherwise) among individuals and different levels of reliance on the calculative activities of other market agents. In each category, the importance of individual interpretative activity and the variations in employment of methods is stressed. The implication for researchers here is twofold: some isolated tests of the efficacy of specific charting methods may lack validity in the real world, and also a concentration on the ability of charting methods to develop excess profits neglects the importance of these methods as heuristic devices located within the broader interpretative skills of their users. We do not claim that our findings, based on a limited group of interviewees, are representative of the universe of investors as a whole, but suggest a number of exploratory propositions that can be tested in future research.

Article structure

In the following section we examine previous studies of technical analysis. These show that charting is widespread, but offer mixed evidence of its success at providing excess profits. We introduce the SSF research project and explain how this literature provides an avenue for better understanding of the calculative activities of chartists. This is followed by an explanation of the research method adopted and an interpretive analysis of interviews detailing the activities of 12 non-professional investors in the UK who use charting tools regularly. The post-analysis conceptualisation derives a four-way taxonomy of investors based on their calculative methods and market ontology. The discussion then examines the most important aspects of this conceptualisation, and suggests a number of propositions for future research. The conclusion highlights that this study has important implications for earlier and future research, as well as for practitioners.

Previous studies

Two streams of research have considered charting. Researchers in finance have concentrated on showing the popularity of the method and testing its usefulness as a method of investment selection, while SSF research has focused on documenting charting as a socially situated practice. This section explains how these two streams of research are drawn upon to guide our study.

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