



## Risk Control for Advisors

A risk-management tool that just might save your business

By Michael Kahn

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If you believe the direction of the markets has anything to do with emotions and sentiment, then you need a tool to help get a handle on them. What if there was something that would have tipped you off to the changing investment landscape in late 2007, before your clients were calling you demanding answers? Would you be interested?



Of course you would.

What if I told you that tool was called technical analysis? Most of you just rolled your eyes. Before you click to the next article, however, ask yourself why the price of your favorite diversified mutual fund tanked 50 percent last year.

Was it the Bear Stearns collapse? The Madoff Ponzi scheme? The failure of Fannie Mae and Freddie Mac? Despite their significance, the stock market started to fall many months before any of these happened. The reason is that the market itself knew that some very big problems were going to come to a head, even though the fundamentals still seemed quite sound.

Often there is a disconnect between the fundamental definition of value and perceived value reflected in the stock price. How many times has a company released blockbuster earnings only to see its shares begin to fall?

Better yet, how many bear markets began just when the fundamentals looked great? The answer is – all of them.

Wouldn't it be great to identify market trends before you lose money? Keep your mind open and enter the world of technical analysis.

Technical analysis, or charting, is the study of the ebb and flow of real money as it changes hands. It is not the mysterious voodoo



portrayed by some in financial planning and investment management circles. It is merely a tool used to assess risk and reward and supply and demand.

No voodoo there. It need not replace your current methods of fund selection and asset allocation. Our firm uses it as a tactical enhancement to supplement our core investment approach. We also use it to validate ideas because, at the end of the day, the only thing that matters is what the market thinks. The charts tell us just that.

Clearly, there is a psychological component to all of this. Psychology, or investor perceptions, is the only thing that can explain why any stock does not trade at what might be considered fair value.

Technical analysts simply look at the chart to see what is obvious. Is the general trend of prices rising? That's good. Is the stock trading sideways in a choppy manner? Or is the trend of prices falling?

All of these questions help determine if a bull or bear market is in place or if the stock is just marking time. Chartists simply buy stocks in rising trends and sell them in falling trends. When there is no trend, they wait for prices to move higher or lower from patterns and follow along with what the market is telling them.

Oversimplified, to be sure, but it really is not rocket science. . The best way novice chart readers can begin to use them is to first do their own research, whether it is fundamental or any other discipline, and then see if the chart agrees.

For example, you might believe a stock has good earnings prospects, is a leader in its industry and a respected analyst has just upgraded it to a "buy." However, the chart shows that prices have been rising nicely for nearly a year before making a sharp break lower. Could it be that the market thinks that all the good news is already priced into the stock and profit-takers have begun to get active? Perhaps this great company does not have such a great stock.

Technical analysis is widely accepted today as a valid investment approach and there are professional organizations around the world devoted to its study – including major universities teaching for-credit courses.

Don't take my word for it. In 2005, the Financial Industry Regulatory Authority (FINRA) authorized both the NASD and the New York Stock Exchange to accept the Chartered Market Technician (CMT) exam as a substitute for the series 86 exam required of all Wall Street fundamental analysts. The regulators have put technical analysis' CMT exam on par with fundamental analysis' CFA.



Please take this one thought with you today: Technical analysis is the study of market action and market participants, and its goal is simply to get you on the right side of the trend.

For more information, visit the Market Technicians Association at [www.mta.org](http://www.mta.org) or the local technical analysis society in your home country.

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