And the chart says: oh dear God no

Dan McCrum Mar 19 09:52 13 comments

If you ever look at a price chart and are tempted to bring up the technical analysis tools on your ~~Bloomberg terminal~~ data provider of choice, or ponder the Ichimoku Cloud, there's an academic paper getting plenty of attention you might consider.

In essence, if you are an individual investor trading options on the basis of technical analysis, you have made some very poor decisions.

> Overall, our results indicate that individual investors who report using technical analysis are disproportionately prone to have speculation on short-term stock-market developments as their primary investment objective, hold more concentrated portfolios which they turn over at a higher rate, are less inclined to bet on reversals, choose risk exposures featuring a higher ratio of nonsystematic risk to total risk, engage in more options trading, and earn lower returns.

Those returns are dramatically lower, by the way.

> We estimate that for our data, technical analysis costs investors on average approximately 50 basis points **per month** in raw returns from poor portfolio selection decisions, and 20 basis points from additional transaction costs. Notably, the impact of technical analysis is concentrated among high derivative rollers, where the costs are much higher: 140 basis points in raw returns, and 29 basis points from additional transaction costs.

Or to add it up, a cost of about 8.5 per cent a year for normal traders, and about 20 per cent a year for high rollers.

The work by researchers from the business school at Maastricht University, Netspar and Leavey School of Business, Santa Clara University is an important addition to the slim canon on muppet behaviour.

The central previous work appears to be Lewellen, Lease, and Schlarbaum, from 1980, which studied transactions between 1964 and 1970. The new study tracks Dutch investors between 2000 and 2006.

But there may be broader lessons for the dabblers who don't rely exclusively on technical analysis, but do pull up a chart now and then as part of their fundamental analysis.

> The pattern recognition techniques of technical analysis are highly suited to the formation of judgements about short term security price movements. In this regard, Roberts (1959) points out that technical analysis can induce judgmental biases as investors identify patterns they mistakenly believe to have predictive value.

Although the paper also reminds us of the very poor performance of products sold by the professional options traders of managed futures, so maybe there is some application beyond individual traders.

Either way, the authors have a broad conclusion.

> The general advice from behavioral finance for individual investors is that they restrict their attempts to beat the market, and instead invest most of their portfolios as if markets were efficient (Shefrin 2000). Doing so helps them avoid shooting themselves in the foot as a result of falling prey to their own psychological vulnerabilities. Our findings suggest that this advice is apt for individual investors using technical analysis, especially if they are trading options online through a discount broker.

Friends don't let friends ride the Elliot Wave.

Related links:
Technical analysis: Staying on top of the ups and downs – FT
Trader: Commodities – FT (2009)

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