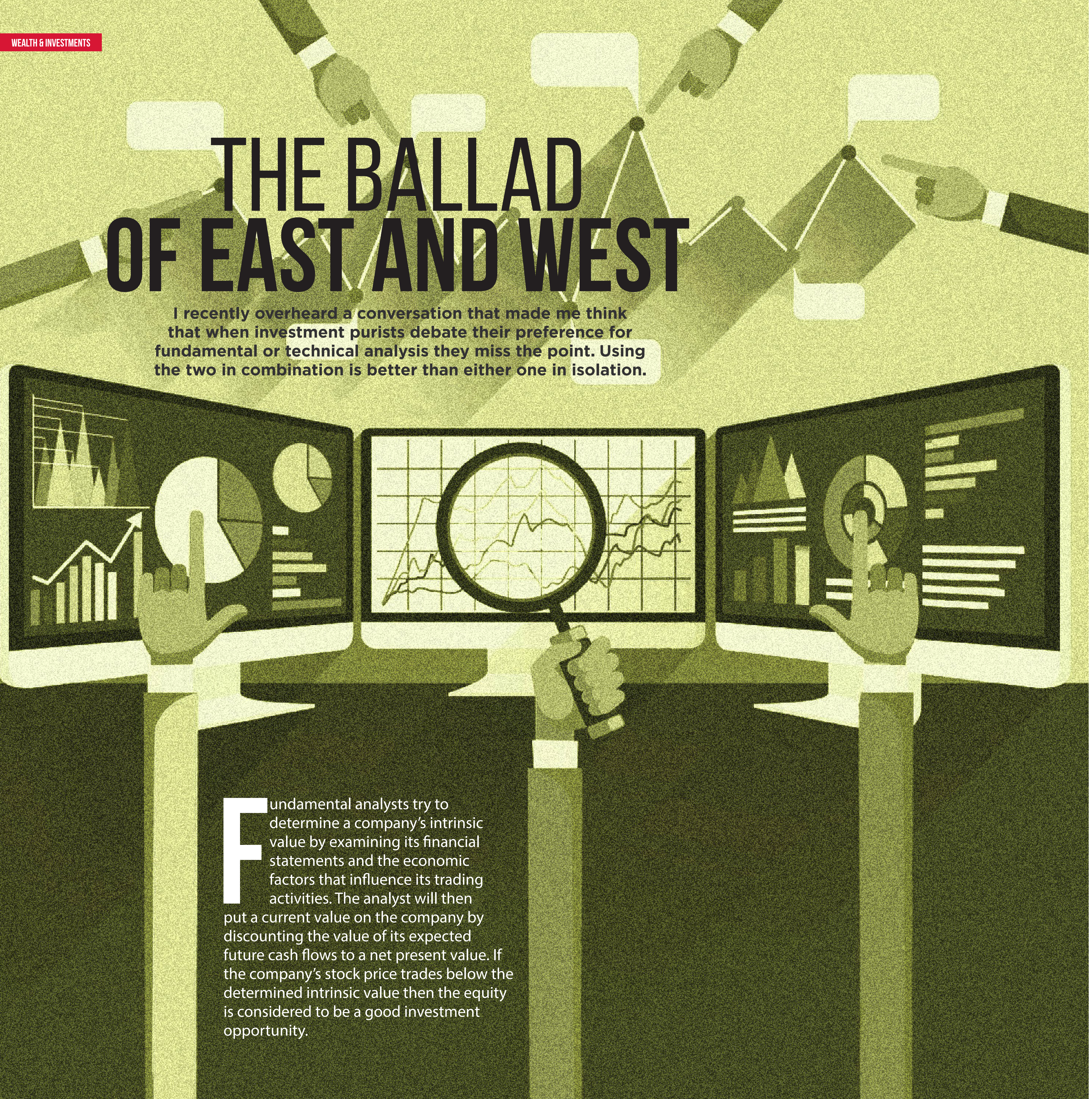

THE BALLAD OF EAST AND WEST

I recently overheard a conversation that made me think that when investment purists debate their preference for fundamental or technical analysis they miss the point. Using the two in combination is better than either one in isolation.

Fundamental analysts try to determine a company's intrinsic value by examining its financial statements and the economic factors that influence its trading activities. The analyst will then put a current value on the company by discounting the value of its expected future cash flows to a net present value. If the company's stock price trades below the determined intrinsic value then the equity is considered to be a good investment opportunity.

Technical analysts, by way of contrast, believe that a company's share price already reflects all of the relevant underlying information, or that, given their circumstantial limitations, analysis of fundamentals can add little overall value that is useful for decision making. The technical analyst will instead look only at the historic price movements of the company's stock and use this data to try to predict and profit from future movements.

The investment time horizon for the two approaches can often be very different. Fundamentalists look at data over multiple quarters or years and will take a position in what they see as an under-priced stock in anticipation that the stock price will correct over the longer term, which could be several months or years. Technical analysts, meanwhile, delineate stock charts in weeks, days or even minutes and their investment outcomes are typically realised within one day to several weeks.

It is not uncommon for fundamentalists to mock technical trading as a black art which lacks substance. Traders, in turn, cite the Efficient Market Hypothesis strong form argument that today's stock price reflects all future news and thus fundamental analysis is wasted effort. Of course, ironically, the EMH also argues that stock prices move in a random walk and, like flipping a coin, a series of previous 0's or 1's has no relation to the next move.

However, surely, the two approaches are not mutually exclusive and it is the balance that yields the best results for most investors. It has to make sense to become comfortable with a company's fundamentals and planned business activities; and then to use technical analysis to determine what seem to be sensible entry and exit points for its shares.

Recognising an upward or downward stock price trend in order to take a long or short investment position is perhaps the most important concept in technical analysis. Longer term trends are generally more powerful than shorter term ones and, whilst short term positions can be taken in the latter, the rewards are generally less and at a higher risk.

Immediately behind this is the concept that many stock prices have periods where they move sideways, or indeed upwards or downwards, within defined channels. Recognising these and taking long or short positions at the bottom or top of the channel has a reasonable probability of yielding a positive return.

Of course, even persistent trends or channels come to an end and the investor must be aware for break-outs on either side which can then result in significant follow on price movements.

Depending on the view, target prices are set at defined points to the upside and the downside of the current price and, once reached, these targets then act as decision points whether to buy/sell the position or indeed to readjust the target prices.

Support and resistance levels are prices that individual stocks routinely struggle to get below or above. Recognising and using these within the strategy adds to the probability of making profits.

Proponents of the EMH will not like the fact that this is particularly the case if the major support/resistance levels happen to be at round numbers (10, 25, 50, 100, etc), which can be important psychological barriers/triggers for market participants. Buyers and sellers will often purchase/sell large amounts of stock once the price hits a major round number milestone.

Whilst it is their glamorous cousin, the share price movement, that grabs the limelight; underlying trading volumes can be wrongly neglected. The amount of market activity driving the share price direction is important, and changes in volume can often precede changes in price.

A share price trend with a high volume of buyers/sellers typically has more strength and will persist for longer that one with a lower volume. Conversely, if a stock price breaks out from an existing trend in a new direction but with a low volume of underlying trading activity, it is often a warning sign that the break out might not persist.

We have focussed herein on equity markets. Although transactional charges tend to be higher, they are particularly attractive for both fundamental investing and technical trading strategies given their overall propensity for longer term price appreciation. However, most fundamental and technical investment strategies are transposable to other asset classes and particularly the foreign exchange markets.

Finally, hedge funds come in many shapes and sizes but one of the most commonly used (and liquid) strategies for start-ups, and which is relevant here, is the long/short equity strategy. This involves taking long and short positions, usually with an overall bias toward the former, in publicly traded equity and equity derivative securities and using a wide range of fundamental and quantitative techniques to make investment decisions.

Occasionally these articles elicit comments or feedback and if you have any on this or any subject please do let me know.

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