

SCIENTIFIC EVIDENCE SHOWS WHY YOU MUST GO WITH
TECHNICAL ANALYSIS

PROFITABILITY OF TECHNICAL ANALYSIS:

A CHALLENGE TO MARKET EFFICIENCY



TIMING IS CRITICAL

BEATING THE MARKET WITH
THE CHANNEL BREAKOUT
AND
THE F-1 TRADER RULE

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FOREWORD BY PROFESSOR HANK O. PRUDEN

OVERVIEW

Investors often ask these questions: Does technical analysis work? Is it of any value to the investor as an investment tool to forecast market trends?

Even as the controversy continues on the efficacy of technical analysis, there is a growing trend in Malaysia where more newspapers, magazines, media and Internet financial portals feature technical analysis reports in their columns. If technical analysis does not work, have they been doing the wrong thing all this while?

This book is an attempt to answer these questions. The author studied 38 active Malaysian stocks and ran 13 trading systems over 7 years to test if their returns are greater than those of the buy-and-hold strategy. The results show that technical analysis tools as represented by the technical trading systems do in fact work, confirming that the Malaysian stock market is not a random walk. The results also show that 6 trading systems consistently beat those of the buy-and-hold strategy, verifying the usefulness of technical analysis as an instrument that can be used lucratively for trading in Malaysian stocks. Amongst other findings, the Channel Breakout trading system has been found to be the most robust and profitable tool.

Arising from two unusual but significant events highlighted in the book, namely the Asian financial crisis of 1997-1998 and the limit-down moves of some lower liner stocks in 2005 caused by the bank margin squeeze, the Channel Breakout trading system has also been found to be excellent and robust for timing stock trading under such special circumstances.

Lastly, as a special bonus, the author shares with readers his proprietary trading strategy called the F-1 Trader Rule that can be used gainfully to trade both fast rising and fast falling bubble stocks.

PREFACE

Background Brief

This book has been written to cater to the academician with an interest to establish if technical trading systems and technical analysis can make abnormal returns from the Malaysian stock market.

It is also written especially for analysts and fund managers desirous of using technical trading tools to time the entry into and exit out of stocks.

Last but not the least, this book is dedicated to the ordinary lay investor seeking for proven methods on how to invest profitably in stocks. It has in all nine chapters and is essentially split into two sections.

The first section comprising Chapters 1 to 6 covers a study made on 38 stocks listed on Bursa Malaysia. Under the ambit of technical analysis, 13 technical trading systems were used to analyse the behaviour of the stocks and conclusions drawn therefrom. Test results conclude that the Malaysian stock market is not a random walk, in other words, it is inefficient. Of the 13 technical trading systems tested on the sample of the 38 stocks 6 of the technical trading systems consistently beat the market, namely, 1) the Channel Breakout 20-20, 2) the Channel Breakout 20-10, 3) the Channel Breakout 20-5, 4) the Channel Breakout 15-5, 5) the Directional Movement Index (DMI) and 6) the 5-20 Simple Moving Average trading system.

The second section evolves from the first one involving the study of the 38 stocks, as, arising from the findings of the study, certain lessons were deduced from them and extended to apply to special situation stocks. The author has chosen to categorise these special situation stocks under Chapter 7 (Asian financial crisis from 1997 to 1998), Chapter 8 (limit-down stocks of 2005 from the bank margin squeeze) and Chapter 9 (bubble stocks) and has recommended strategies on how to manage each of them to minimise loss and maximise gain for the market player.

Chapter Overview

Chapters 1 to 6 attempt to answer the following research questions:

- 1) Does technical analysis and technical trading systems work for Malaysian stocks?
- 2) Is it of any value to the investor, analyst or fund manager as an investment tool to forecast market direction?
- 3) If technical analysis works for Malaysian stocks, then which of the trading systems are the most robust and profitable.
- 4) What is the impact of transaction costs on the profitability of technical trading systems?
- 5) How often should one trade, and what is the impact of trading frequency on the profitability of technical trading systems?

The second section, which comprise Chapters 7, 8 and 9 presents tested strategies on how to handle special situation stocks.

- 1) Chapter 7 deals with how effectively could technical trading systems be applied to Malaysian stocks during the Asian financial crisis of 1997-1998, and the determination of the most robust and profitable system. The author then demonstrates how the Channel Breakout 20-20 trading system could have “saved” an investor from the sharp decline in stocks during the Asian financial crisis.
- 2) Chapter 8 investigates why several Malaysian stocks collapsed in mid-2005 and consequently recommends which of the technical trading systems covered in the above study under Chapters 1 to 6 may best be applied to deal with and to profit from a future event similar to that experienced in mid-2005.
- 3) Chapter 9 suggests a practical and effective way on how an investor could possibly profit from trading in bubble stocks. Here, the author reveals his proprietary technical trading system, the F-1 Trader Rule, and demonstrates how it can effectively deal with fast-rising or fast-falling bubble stocks.

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