Why Investors Shouldn't Rely Solely on Technical Analysis

Description

Technical analysis can be a great tool in finding potential buying opportunities on the markets, but relying solely on it can be dangerous. For those that believe you can earn better returns by reading charts than by focusing on value investing, there's only one example needed to prove that argument wrong: Warren Buffett.

Still one of the richest people alive, Buffett has yet to be usurped by a chart reader, and that's not likely to happen anytime soon. While there is certainly the potential to turn a profit by using indicators and technical analysis, there are two examples below of how it can put your portfolio at risk.

Bitcoin

In 2017, we saw Bitcoin rise to astronomical levels for little beyond just hype fueling the cryptocurrency's rise in value. There was little reason to justify its rise besides the fact that it was rising in value. However, as quickly as it rose, it crashed just as fast, leaving many buyers scrambling to sell at whatever prices they could.

When something rises in value for no justifiable reason, there's a good chance we'll see it come back down and for the market to correct the valuation. It may take some time, but that doesn't mean it won't.

Cannabis stocks have long seen obscene valuations and have recently been crashing, as investors start realizing how little substance behind some of the companies that there is.

Home Capital

Also in 2017, we saw the **Home Capital** scandal not just send the stock over the cliff, but rattle the markets as well. The impact that scandals and news-related items have on the markets will always overshadow anything that a chart can tell you about a stock.

New information can significantly alter how investors view a stock and change the outlook that they have for it as well. It also comes without warning, with no regard for what a chart pattern says about the stock up to that point. The markets move based on information, not their own prior movements.

Balance of technical and value could be the key

This is not to say that technical analysis is useless. However, buying shares of a company solely because it has risen in value is a very dangerous proposition and makes you more of a speculator than an investor at that point.

A safer approach would be to eye an attractive stock like **Canada Goose Holdings** (TSX:GOOS)(NYSE:GOOS) and wait for an opportunity to buy the stock. The company makes for a good investment fundamentally, as it has achieved significant sales growth since listing on the TSX, and it continues to be popular with consumers in various parts of the world.

The brand has significant value; however, for investors that don't want to buy too high or that are worried the stock is headed down and want to wait for a good deal to buy it at, technical analysis and indicators can certainly help.

One metric I often use is the Relative Strength Index (RSI), since it helps you gauge a stock's momentum. It looks at how a stock has done over the past 14 trading days. Once the RSI falls below 30, it signifies that a stock has seen a heavy amount of selling (i.e., "oversold") and that it could be due for a turnaround.

Using this with careful analysis to find a good growth stock, like Canada Goose, can help pinpoint a good time to buy a stock that's already been vetted. Canada Goose is a good example in this case, as the stock has proven to be very volatile this year.

Bottom line

Using technical analysis can help you make a strategic decision as to when to buy or sell a stock in order to maximize your returns, but investors shouldn't rely on just an indicator or chart when making investment decisions.

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Author
djagielski