CHAPTER 2

LITERATURE REVIEW

Strategies for making money in the stock market have been tested in a number of studies. Fischer (1971) conducted a study on the implications of the random walk hypothesis for portfolio management and found that fundamental analysis is difficult for most of the investor to gain money as the market competition is so severe. The share price is very sensitive to changes in the prospects for a company or economy that caused the price change so fast that no one has time to make money on the information. He also stated that "the past history of stock price movements and the history of stock trading volume do not contain any information that will allow the investor to do consistently better than a buy-and-hold strategy in managing a portfolio". In other words, he concluded that technical analysis techniques do not work, either alone or as a supplement to fundamental analysis. He suggested that the way to make money in the market is by adopting a "passive" strategy, which is the buy-and-hold strategy.

Lukac and Brorsen (1998) suggested that disequilibrium theory provided another theoretical reason why trend-following trading system might work. The technician who sticks to this theory believes that prices do not quickly adjust to information, hence markets are in short-run disequilibrium. As a result of this sluggish adjustment, price trends exist and using technical trading techniques for profitable trading is possible.

Beja and Goldman (1980) suggested that investors did not act instantly on all information because of transaction cost, taxes, cost of acquiring and evaluating information, and lags in obtaining information. Hence, market can be in short-run equilibrium and speculation based on price trend can be profitable as market is moving towards equilibrium. As a result, the use of technical trading systems which forecast price trends may play an essential role in short-run speculations.

Tomek and Querin (1984) reported that technical trading techniques are always successful, even in a random walk world. They also mentioned that much of the technical rules are judgmental and cannot be tested mechanically.

Nison (1991) pointed out the superiority of Japanese candlestick charting over other technical analysis used with bar charting in his study of Japanese candlestick charting technique. He indicated that Japanese candlestick charting can send valuable signals not available from any other charts. The picturesque terms used to describe the patterns give a clearer picture on the stock situation. However, it also has its limitation where there is some subjectivity in deciding whether a certain candlestick formation meets the guidelines for that particular formation. It is subject to the interpretation of the users. Anyway, this subjectivity also occurs in other charting techniques.

Gifford (1995) indicated that moving average is an increasingly popular way of defining market trend as it is a calculated value and there should be no dispute to show price movement accurately. Even though moving average

has no predictive ability, technical analyst will use this average value as an estimate of where the trend is likely to provide support or resistance on any one day. The study also mentioned that moving average may create false signals from time to time and it is up to the market analyst to make conclusion before making any trading decision.

Ravindran (1997) studied the superiority of technical trading over a buy-and-hold strategy on the Singapore Stock Exchange (SGX). The findings indicated that the superiority of technical trading over a buy-and-hold strategy depends on the technical trading techniques used and the returns from technical trading are not consistent across indices and stocks. He found that technical trading techniques of simple moving average, exponential moving average, momentum indicator and point & figure charting are more profitable compared to buy-and-hold strategy. On the other hand, double moving average, the relative strength index and the cumulative advance-decline indicator were found to fall short of the return from a buy-and-hold strategy.

Loy (1987) studied the technical trading systems in Singapore financial futures market. His findings showed that both logic and empirical results convey that trade based on technical analysis of actual price data can, at times, be profitable.

Shamsher, *et al.* (1995) conducted a study on the economic viability of some commonly used technical analysis tools in the Malaysian securities market. The findings indicated that one should not make investment decisions only

based on signals from technical tools but should also consider the signal generated by fundamental factors. The study found that even though technical tools are useful as a supplementary tool to help investor in making investment decision, they still lack the human intelligence and psychology that cannot be captured in the mathematical equation of the technical tools.

Ahmad (1989) conducted a study on technical analysis in share market forecasting on the KLSE. The findings concluded that economic analysis alone cannot be used to predict market trends because the market is also influenced by other factors other than fundamentals. He also indicated that by following market action and studying its trend, the investor is able to forecast the market future direction more accurately. In short, one needs to study the price chart of the market closely in order to make accurate forecasting.