Brainy's Articles on

Technical Analysis

Avoid paying too much for shares

Introduction

Whenever we spot a rising share price, we can easily feel a sense of need — that we have to buy it so as not to miss out on the rising share price (that's FOMO). The greater the price increase that we see over time, the greater the underlying feeling of FOMO — that we are missing out. And the uptrending share price can go on for just a few days, or sometimes for a few weeks, and sometimes for many months. This can result in an impulsive action to purchase the stock at any price. The longer the uptrend continues, the greater the feeling that we are missing out, and we know that emotions have a great influence over the trading in the share market. However, in many cases there is a price point above which we are chasing hot air. But how do we know? How can we tell if the share price is too high? Perhaps technical analysis can help!

Table of Contents

The fundamental analyst would work through some calculations and some modelling and come up with a theoretical upper value for the stock; but at the end of the day, the only valuation that matters is what the market is prepared to pay on the day. But on some days the market can get way ahead of itself and push a share price unreasonably high. In this case we don't want to pay an unreasonably high price to own the stock.

The sample in Figure 1 at right is just one example of the price running away for no good reason. It shows a single week in July 2009 when a share price rose 400% from 2.5 cents to a high of 14.5 cents before closing down at 12.5 cents. Within days, the price was languishing in a range between 6 and 9 cents. It would have been a challenge to make a profit on this stock at that time.

So, how can we avoid paying too much for shares?

In this Article in Brainy's series on technical analysis, TA-5300, *"Avoid paying too much"*, we take a look at a couple of ways to beware of the trap of paying too much for a stock. In this Article we will describe two ways to derive a *"Maximum Chase"* price level, beyond which we should be cautious about a purchase.

Figure 1: In hindsight, even 8 cents was too much to pay.

When to be careful?

It is easy to pay too much for a stock in a number of situations including:

- At a price breakout above horizontal resistance, where a new uptrend commences.
- At a price breakout above a chart pattern (triangle, pennant, wedge, etc.).
- When a new uptrend commences after a downtrend is confirmed to be finished.
- Once a trend is under way, it is possible to join the trend; but at an opportune point and not at a point of over-price.

Overview

Of all the possible methods to avoid paying too much, there are several that we will consider here:

- ***Percentage*** — Use a rough rule-of-thumb measure based on a percentage of the share price. This would be difficult to automate on a price chart; but can be worth calculating.
- ***CBL*** — Use the recent price range and pivot low swing points as shown on the price chart in candlesticks to set a *Maximum Chase* price level. This method uses the CBL chart tool that is available in some charting software packages.
- ***ATR Multiple*** — Determine a *Maximum Chase* level based on the recent Average True Range (ATR) of the share price. This method uses a chart indicator that can be easily applied to the price chart.
- ***Alan Hull's Range+*** chart indicator.
- ***Candlestick and chart patterns***.

Because we don't have a crystal ball for predicting the future, and because the study of technical analysis is not a 100% guaranteed science, we do need to understand that there is no definitive way to identify when the share price is too high, and that we might be paying too much. What we can do, though, is use technical analysis tools to help us understand the likelihood that a share price might be too high. After all, by applying technical analysis we are trying to understand the likelihood of share price movements based on the opinions of the market participants (whose opinions are on display for us in the price charts).

Why is this important?

Breakout trading is one specific type of trading strategy. Depending on the timeframe employed, this strategy can be readily utilised by longer term investors as well as shorter term traders. One of the risks with breakout trading is that the price can take off, only to retrace to test recent support. It is so easy for the casual investor/trader to spot a potential breakout fairly late in the breakout, and in fact close to the peak just as it is falling, and possibly failing completely. This will often bring the novice undone, and result in a loss of capital. See Brainy's Article ST-6130, *"Breakouts analysed"*, for more details.

Alternatively a share price can surge upwards, and appear to be starting a new uptrend only to stall suddenly and plummet. It is easy for the novice investor/trader to see this upwards push as a new trend and to take a position, only to relax and lose money as the price falls away. Therefore, it is so important to be able to identify possibly unreasonable surges, as well as having a sound money management strategy to help exit the position quickly.

Write down your preferred approach (prepare your strategy)

In terms of strategies for trading and investing, there are many. It is very important to remember that if we invest or trade without some sort of strategy then we are bordering on gambling or speculating. The process of creating a *Trading / Investing Plan* and a *Strategy* forces us to think through our ideas and to crystallise them, rather than leave them as vague notions in our head. And the plan and strategy must be written down. It makes a lot of difference to have these written down and sitting on the desk in front of us.

Having said that, there are some people who can trade successfully without a written strategy, in which case they are trading in a *discretionary manner*. In order to do this successfully it is said that we need 10,000 hours of experience. Until we have had enough practise and hands-on experience, we are running risks.

What is a realistic price increase?

In the normal course of the market, a stock's share price might rise or fall up to about 5% in a day, or perhaps 10% to 20% in a week, and sustain the increased prices over the short term. But a stock that increases 50% to 100% in a day cannot usually maintain the higher prices before a sell-off.

Unfortunately,
the remaining pages of this article
are not available for free.

Some of the eBook Articles are available for free,
including the Table of Contents pages,
and the Introduction and Overview pages.

These articles take a lot of time, experience,
knowledge and expertise to compile.

However, there is some good news.

You can subscribe as a Toolbox MEMBER
and have unlimited access to all Articles,
plus a whole lot more.

Visit: www.robertbrain.com

Robert writes and updates Articles on three topics:

- ✔ Share Trading & Investing
- ✔ Technical Analysis
- ✔ BullCharts (charting software)

See a list of Articles in the free section of the Toolbox:
www.robertbrain.com/members-area/articles.html
(the green shaded articles are free)