

Fundamental versus Technical Research

*Article Provided by Integrity Research Associates for Fidelity Investments**

One of the livelier and long-lasting debates in securities research is the relative merits of fundamental research and technical research. Fundamental research focuses on identifying and analyzing the factors that influence security prices whereas technical analysis is solely concerned with analyzing market behavior, without concern for trying to explain it. Given the sharp differences, it is easy to understand why proponents tend to favor one over the other.

Advantages of Fundamental

We are curious animals and naturally want to know the reason why things happen. Fundamental research seeks to satisfy the urge to understand what makes stocks and markets move. The primary purpose of analyzing fundamentals is to make judgments about which investments to own or when to buy or sell. At a more basic level, it is hard for many of us to make investments without having a rationale. Peter Lynch's mantra, "Invest in what you know", invites investors to do their own fundamental analysis drawing on their own direct experience.

Fundamental analysis gives the tools to understand the underlying value of securities and to determine whether securities are under- or over-valued. Fundamental analysis can be applied to all types of securities, whether equities (valuation), bonds (credit risk), or commodities (demand/supply). It can also be applied to broader markets through economic analysis and investment strategy.

Fundamental analysis is backed by academic theory and has a broad set of practitioners. Fundamental research is the most popular category of investment research. Nearly forty percent of the research firms Integrity Research monitors perform fundamental research, making it the most populous category of research.

Advantages of Technical

Technical analysts focus on extracting information from the market itself. One example is market trends. Markets and securities develop trends, whether up, down or sideways, and technical analysis is adept at measuring the characteristics of those trends. Momentum investing is a form of trend-following investing used by a variety of investors. Technical analysis is an important tool for momentum investors, especially in determining when trends change.

A new area of study is behavioral economics, which studies how investor behavior impacts securities markets, particularly market anomalies and irrational market behavior. Behavioral economics has drawn attention to technical analysis. Technical analysis lends itself well to irrational markets since it focuses dispassionately on market movements. In addition, technical analysis incorporates behavioral elements, such as measures of market sentiment. Technical analysis is the closest thing to behavioral analysis of investments.

Traders are heavy users of technical analysis, partly because it can be applied intra-day and well as over longer periods. Like fundamental analysis, technical analysis also works across different types of instruments, from equities to commodities to foreign exchange markets.

Globally, the industry is represented by The International Federation of Technical Analysts (IFTA). In the United States the industry is represented by two national organizations: the Market Technicians Association (MTA), and the American Association of Professional Technical Analysts (AAPTA).

Which to Choose?

Some of the firms offered through Fidelity.com combine technical analysis with other types of analysis in making their recommendations. Examples include Channel Trend, Market Edge, Ford Equity Research and Ned Davis Research. Ford Equity Research, for example, combines fundamental analysis such as earnings quality and securities valuation with a final overlay of technical analysis. As Ford expresses it: “As a final input, the long-term and short-term price performance is studied to determine the near term potential for price gain.” Because of controversies associated with technical analysis, some firms use other terms, such as “investor behavior” or “price behavior analysis”. These are code words for technical analysis.

If successful research firms have no qualms using technical analysis, you shouldn’t either. You can see technical analysis in its purest form by looking at Recognia’s research on Fidelity.com. The reality is that technical analysis offers insights which fundamental analysis can’t provide, particularly as it relates to timing and momentum. The best approach is to use all the tools at your disposal, using both fundamental and technical analysis in arriving at an investment decision.

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