







forming their views, and Menkhoff (1997) reported that 87% of them use it for their decision making. Further evidence of the popularity of technical analysis is represented by the number of published textbooks on this topic, which include those by Murphy (1999 – a bestseller in Financial Risk Management on Amazon), Wilder (1978), Pring (1998), Schwager (1999), Edwards and Magee (2010) and DeMark (1994) – these being only the best known among many others. However, this approach has many limitations. Below, we highlight seven pitfalls that one runs into when following it.

### **Pitfall #1: “Subjectivity**

Pring (1991) makes the following statement concerning technical analysis



As can be seen, the total number of trades is more or less stable, whilst the successful ones fluctuate around 60% of the total, which suggests potential profits from trading. However, the other parameters vary considerably over time, which implies that there is no guarantee that the trading strategy will be profitable. In fact, it turns out to be unprofitable (i.e., the financial result is negative) in all periods. The absolute drawdown (the difference between the initial deposit and the minimum point below the deposit level) is also unstable and much greater than the financial result. Thus, there is a negative risk/profit ratio for the trading strategy based on the RSI indicator.

### **Pitfall #5: “Data snooping”**

Textbooks provide many examples of technical analysis producing accurate forecasts resulting in profitable trades. However, this is simply a case of : it is no wonder that out of the huge number of indicators and methods used by technical analysts (such as trading algorithms based on different



different types of time series models (AR - autoregressive models, ARMA - autoregressive moving-average, ARIMA - autoregressive integrated moving average, VAR - vector autoregression, etc.) can be estimated to predict future prices using appropriate model selection criteria (information criteria such as AIC - Akaike information criterion, BIC - Bayesian information criterion, MML - Minimum message length method, etc.). It is high time that technical analysts start using such methods to gain a deeper understanding of price behaviour as the basis for their trading strategies.

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