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The Limits of a Purely Technical Approach

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One trap that many technical traders fall into is trying to find the one or two indicators that will produce a regular and steady flow of profits. They believe that if they just find the right combination of moving averages, stochastics, relative strengths or whatever, they can hit the buy or sell buttons when things align the way they should and take the profits to the bank. The market goes through cycles, and human behavior and emotions tend to be pretty repetitive, so quantifying things in mathematical terms shouldn't be that difficult -- right?

The search for the technical holy grail has gone on as long as the market has existed, and there have been systems that work for periods of time. Backtesting is a major industry, and there are all sorts of programs available that claim to have developed algorithms that will make you rich if you just follow the red and green signals.

There even have been some big hedge funds that have developed complex "black box" systems to trade the market. One of the most famous, and most secretive, was run by Ed Thorp, who wrote one of the first books about card-counting and blackjack basic strategy.

Mechanical trading systems can work, but few of them are adaptable to the ever-changing market environment. A system that uses a momentum scheme will break down in a trading-range market, and a system that focuses on overbought conditions will underperform in a strong trending market.

If you are tempted to believe that a couple of technical indicators can deliver consistent profits, ask yourself why the technicians employed at major Wall Street firms who spend millions of dollars on research aren't simply programming their computers to do such things. Why aren't the folks who spend their lives developing mechanical trading systems simply using the indicator that you like to make millions?

Despite all our efforts to quantify and understand the market, it will always be random and unpredictable to some extent. It simply is not possible to predict the news or how people will react to it. There are some things that remain constant, but not to the degree that we can ever be confident that we can capture the swings in the market through the use of a couple of simple indicators.

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