FINANCIAL STRATEGIES ROUND-TABLE

Abstract

What representations of financial markets do market participants have? This article shows that the markets are the site of an irreducible conceptual diversity: there is no consensus on how to "win" in the stock market, and this disagreement is, paradoxically, necessary for the existence of financial markets. The diversity of representations is illustrated by the age-old debate between supporters of fundamental analysis (the study of the financial health of listed companies) and those of chartist analysis (who look for characteristic forms in price curves that allow them to predict their evolution in the short term). This debate is presented in the article through the sociological analysis of a trading forum dedicated to *chartism*. The author concludes by emphasizing that conceptual diversities intersect with social diversities.

Original French Article:
Godechot Olivier. 2008. "Stratégies financières autour d'une table", *Regards croisés sur l'économie*, vol. 1, n°3, p.144-156. DOI: 10.3917/rce.003.0144. URL : https://www.cairn.info/revue-regards-croises-sur-l-economie-2008-1-page-144.htm
English translation (2022) with DeepL © and authors' edits.

How to cite this translation:
Godechot, Olivier. 2022. "Financial Strategies Round-Table". Unpublished translation of " Stratégies financières autour d'une table", *Regards croisés sur l'économie*, 2008, 1(3): 144-156.

FINANCIAL STRATEGIES ROUND-TABLE

Olivier Godechot

On a podium, behind a table, seven professionals debate the respective merits of two classic financial strategies: "fundamental analysis" and "technical analysis". Fundamental analysis relies on the study of the financial health of companies and the economic situation, whereas "technical analysis" (or "chartism") is based the identification of characteristic patterns in prices that enable price changes to be anticipated. In front of them, an attentive audience of three hundred people, mainly composed of small investors, 90% of whom are men and a good third of whom seem to be over the age of retirement, listens attentively and asks a few questions that have less to do with the ins and outs of this century-old controversy than with the stock market predictions of professionals. This one-hour debate takes place during the *Trader*'s Forum, an annual, free, two-day promotional event organized for several years by Roger Bompoint [1].

Time for a debate

The debate is moderated by a journalist from a major financial newspaper. On the side of the supporters of technical analysis, there are two leaders of stock market consulting firms, Roger Bompoint and Olivier Blumenfeld, as well as Ali Bouazi, author of a book on the great *traders*, a book somehow in between professional and academic world.
On the other hand, two portfolio managers, as well as Yves Sainte-Croix, author of a book on the virtues of fundamental analysis and head of a large Anglo-Saxon bank, were present.

The journalist invites the latter to open the debate. To clear the air, he apologizes for coming to support positions that are both favorable to an investment logic and critical of technical analysis in such a place. It is a bit like "exposing yourself to the lion's den". He continues by evoking the theme of "market efficiency". By practicing chartism, "it is difficult to beat the markets". According to him, there is a lot of "back and forth" in the short term, i.e. buying followed by selling or selling followed by buying back, movements that are almost as winning as losing. On the contrary, if one manages to identify undervalued

1 . The names of the speakers and events have been changed.

companies, buys them and holds the shares for three to four years, without paying too much attention to erratic short-term movements, one will ultimately make higher profits [*Mathieu L'Hoir*, p. **133**].

Blumenfeld and Bompoint first give ground to their colleague to better delimit the field of validity of their strategies. According to them, technical analysis does not enable to forecast for long horizons of two or three years, a time frame where fundamental analysis could take over. But in the short term, fundamental analysis is unable to predict stock market movements. *Trading*, of course, is not for everyone, they say. Technical analysis is not a crystal ball. To be right with technical analysis in 65% of the cases, insists Blumenfeld, it is an excellent score. The fundamentals of *trading* are reiterated: "Cut your losses and let your gains run." But for those who don't want to "get bored" holding stocks for three years, who want income quickly, those who have a bit of a speculative temperament and who know how to bend to an iron discipline, technical analysis can be, according to Bompoint, an excellent method both in the short term (daily *trading*), but also in the medium term (several weeks).

The journalist asks a portfolio manager if he uses *trading* and *charts* when markets are turbulent. The manager first details the regulatory constraints that weigh on him and limit the final part of the *trading*. But he admits to using "technical points" to "enter the market" or "exit". This manager, presented for the debate as a supporter of fundamental analysis, is therefore not hostile to chartism. On the contrary, he has been using it for ten years, and has acquired a certain skill in it, to the point where he now produces analyses for his colleagues. At the same time, he nuances, it remains an auxiliary. It is the fundamental analysis that allows him to select the most interesting securities, and then the technical analysis that helps him to calibrate his intervention rhythm.

After this first round, the audience was invited to ask questions. Two retirees in the front row ask for the forecast of the CAC40 index evolution in the next weeks (then located between 5670 and 5680 points). Blumenfeld and Bompoint make opposite diagnoses. The first one predicts a continuation of the rebound observed in the previous days, a test of the 5800 and 5900 points thresholds, and in the next months surprises, like the possibility of reaching or even exceeding the records of the year 2000 (6900 points). Bompoint thinks instead that the CAC will test the 5800 barrier, once or twice, and that it may then drop back down to the 5500s, or even very low, somewhere in the 4000s. A discussion follows on the reasons for this contradictory analysis. Both technical analysts see this divergence less as a disavowal, a sign of incompleteness, lack of seriousness or fragility, than as a source of wisdom, a sign of openness and flexibility. Technical analysis is an open framework for building a multiplicity of scenarios. One is favored, but alternative scenarios are not neglected. Bompoint suggests introducing a *stop loss* (an order with a trigger point) to turn the position around

if it enters the 5900 area, which would invalidate its main scenario and force it to rethink a new scenario.

The moderator takes over the debate to re-launch it on the confrontation of approaches and avoid that the requests for advice from individual stock market traders confiscate it. From time to time, the conversation becomes animated with little jabs from the technical analysts against the "fundamentalists" and *vice versa*. Bompoint is pleased that portfolio managers are using technical analysis a little to know how to make the right entries and exits. If they used it all the time, it would be even better.

The animation resumes around the round table when Sainte-Croix talks about the great figures of the stock market who, like Warren Buffet, have made a lot of money by holding shares for a very long time, 3 or 4 years. As a responsible man, he wants to warn small holders. Technical analysis is "complicated". It is better for him to leave these methods to the professionals, because, if not, one risks losing as much as one gains... Certainly the technical analysis can work in the very short term, because, he lets go of the word, it is "AUTOREALIZING". "Tut, tut, tut" makes Bompoint in his corner. He boils.

Blumenfeld resumes Sainte Croix: "I prefer that one says: 'I don't like technical analysis' rather than to say it is 'self-fulfilling'. Fundamental analysis, it is just as self-fulfilling. [...] When a financial analyst says that you should buy because this and that, and the market follows, it's just as self-fulfilling. Technical analysis, he says, is the analysis of what people are doing! It's an observation!" Bouazi, discreet during this debate (he talks a little about the psychological qualities of great *traders*), warns in a more academic reflective style, that the label "self-fulfilling" is depreciatory, but that it is not impossible that this dimension plays some role in the success of technical analysis, as suggested by some economic models of behavioral analysis.

Bompoint ends with a vibrant plea for technical analysis. His theatrical tirade even becomes moving: "We are not very smart! No, you don't have to be very smart to use technical analysis! It's not difficult! It's fun! It's much less boring than reading hundreds of pages of financial reports that basically say... not much. We don't pretend to know where the market is going! We just get behind the others. We are wheel-suckers. We follow them. We follow the big volume!" He points to portfolio managers: "You're the big volume! Technical analysis is a translation of what the players are doing. If it was pure self-realization, it couldn't work, because there would be no market."

A recurring debate

This little debate is a manifestation of a controversy that will soon be a century old about the respective merits of different financial strategies. This

controversy is neither exclusively scientific, nor exclusively technical, nor exclusively economic. It mixes these different levels and actors from these different worlds. Its stakes are not reduced to truth alone, to technical efficiency alone or to simple monetary profit, but always constitute an unstable combination of these three elements. Economists have been involved in this controversy with multiple objectives since the 1930s [Cowles, 1933]: it was as much a matter of demonstrating the vanity of the advice of financial intermediaries, these "applied economists" as of trying to establish statements for the attention of the scientific community on the beneficial (or not) nature of markets. This strategy of unveiling did not prevent these economists from occasionally keeping an interested eye on the financial profitability of their findings [MacKenzie and Millo, 2003, p. 33]. The same ambivalence can be found among market professionals. If they oppose each other at first sight in order to exploit above all the chances of profit, they do not disdain theoretical controversy in order to show the superiority of methods to which they are attached. As Charles Smith [1999] reminds us, the markets are not only populated by "market salesmen", agnostic and opportunistic operators ready to promote any method as long as it generates financial flows that are favorable to them, but also by "true believers" who think they have found *the* key to understanding the market, a key that they experience intellectually by winning and making money. It is within these different "true believers" that the most lively debates emerge. Their typology ("fundamentalists", "contrarians", "chartists") is not closed [Davanne, 1996; Smith, 1999]. However, we always find these two poles in the debate: fundamental economic analysis and chartist analysis.

The "believers" evolve in a world now impregnated by modern financial theory, as shown by the mobilization by the participants in the round table, in front of an audience of amateur financiers, of market efficiency [*Valérie Mignon*, p. **104**], of self-fulfilling prophecies [*André Orléan*, p. **120**], and of implicit volatility ["*Les principaux modèles de prédiction des cours"*, p. **141**]. The financial markets, behind their very prosaic appearance, are indeed in a sense a *reflexive* institution: its members constantly discuss its meaning and its evolution ("What is the market? What does the market do?"), a reflexive activity that does not remain at an overhanging level but participates in its constitution.

Chartists on trial

This quarrel over methods is often reduced to a controversy focused on one of them: chartist analysis. In fact, fundamental analysis as a method of speculation fits better into the analytical framework proposed by the theories of efficient markets. It is both a superfluous and indispensable complement. It is indeed futile to try to make money by assessing the fundamental value of

companies if the markets are already assessing them at their true price. At the same time, these same markets could not do so without their players following this approach on a permanent basis. On the other hand, the fact that chartist analysis can make money is for many actors a real intellectual scandal. Its existence and persistence constitute a challenge not only for financial theorists - especially neoclassical ones – but also for professional actors. To the questionable starting point – the past of the price as the essential source of its future evolution – is added for these opponents a method that seems to be based more on analogies, proverbs, and almost esoteric considerations than on an analytical and systematic approach – such as that adopted by statistical[2] *trading*. To silence the scandal, the simple criticism of the chartist analysis is not enough! It is necessary to explain it: to reveal the bad reasons that lead to its adoption or the unexpected reasons why it can make money. If we want to do a sociology of finance (and not a sociology of science), we cannot be satisfied with a simple agnostic and overhanging reading of the argumentative structure of the controversy. On the contrary, one must "follow the actors" from the debates to the practices, including when this leads to testing or repeating their arguments.

"Financial markets, behind their very prosaic appearance, are a *reflexive* institution: its members are constantly discussing its meaning and evolution."

Chartist analysis brings together a series of techniques that consist of identifying signs in the past price that herald the future price. The most commonly used technique consists of tracing lines on the price, usually horizontal, passing through one or more local extremes of the price (*see* box). The price is supposed to hit and rebound on these lines, which are called "resistance" (on the upside) or "support" (on the downside), unless it "breaks" them and then carries the price to the next line. Moving averages (most often 20-day or 50-day) are another widely used indicator. When the price crosses the moving average on the downside, it is a sell signal. When it is rising, it is a buy signal. In the vein of moving averages, a large number of indicators have been developed, such as the Bollinger Bands, the RSI, *etc.* Others are even more esoteric, such as Elliot waves or Japanese candlesticks, which contain a series of adages about price movements.

2 . Statistical *trading* can be seen as a sophisticated form of technical analysis: it consists in finding, through *datamining* and statistical models, significantly predictive patterns

The reasons why these indicators are effective remain rather unexplained: "it's because prices follow trends" or "because it works". These answers will not convince the most doubtful financial operators: they do not see why possible trends would be announced by such rudimentary and vague indicators. We sometimes find in the speeches of chartists or their books more behavioral explanations of the relevance of indicators. As Bompoint explains with Callon-Latourian accents, chartist analysis is a "translation" of market activity. It consists of isolating certain transactions and certain actors and setting them up as representatives of market activity, while considering other actors as noise [Callon, 1984]. When a price turns around and goes up again after having drawn a local minimum, the chartist identifies a bullish current triggered by one or more "big" players, someone who is perhaps an insider, who knows the market and handles a large volume. This minimum would then become a support on which the price could rebound in the future. The assignment of a rebounding capacity to an extremum of the past price is also based on the identification of players and the assignment of a "psychology" and of biases (over-attention to the past potential for gain): during a rise, both buyers who wish they had bought more, sellers who would like to get rid of a contrarian position at lower cost, those who have just sold regretting having exited too soon, or those who have never traded in the stock and would like to be in it, wait for the price to return to its last minimum before buying [Murphy, 2003, pp.68-69]. For an efficiency follower, such an identification might seem quite arbitrary. The very idea of a bullish current does not make much sense. Any transaction is an equilibrium between supply and demand: there are always as many securities bought as sold. The privilege given to the extremes arbitrarily leaves aside the non-negligible range of transactions realized between them. Academic work, the main place where financial market theory is produced, concludes instead, with statistical tests to support it, that technical analysis is relatively ineffective, in a very definite way yesterday [Fama, 1965] and in a much more nuanced way today. Technical analysis would not make more money than the simple *hold-and-keep* strategy, once one takes into account transaction costs and risk costs [Griffioen, 2003].

An example of technical analysis published on an online stock market site

TRUC SA : triangle exit

Medium-term context:

Over the last few months, TRUC SA has been rising. The rebound on the major support at EUR 19 allows us to envisage a new phase of increase. We have been bullish in the medium term since 22/08/2007.

Short-term forecast:

Our previous opinion was neutral: prices have risen significantly and we change our view. The bullish exit of the triangle gives a new signal. Our view is favorable in the short term with a target of 23.8 EUR. The invalidation is placed below 22.15 EUR (at the close).

Last price : 22.59

Performance / Jan [1]: 7.876

Opinion: positive

Trend: bullish

Support : 22,35 / 21,6

Resistance: 23.8 / 24.37

The flexible operation of chartist analysis

Statistical tests, which have a rather negative tone but contradictory results [Osler, 2000], cannot serve as definitive proofs to close the controversy and put an end to an activity that has become an industry, because they only imperfectly represent the practice by focusing on its most deterministic rules, such as prices crossing of their moving average. They therefore miss what makes it original: its great flexibility.

The positioning of a support level or a trend line on a price is often described as "subjective", a characterization used as a reproach by critics, but often assumed by its followers. Thus, we can see that the choice of the support level of 21.60 in the box is not obvious: there is no lack of local extremes to place it at 21.50 or 21.70. Once drawn, the levels produce an obvious effect that they did not have before. Even the more mechanical indicators such as moving averages are not unambiguous. Depending on the choice of period (50 days, 200 days), they produce divergent indications. Chartists usually have a battery of indicators offering more or less contradictory signals, from which they have to make a personal selection. Faced with so much malleability, opponents consider that technical analysis is a way of not taking responsibility for one's decision and of not working on the intuition on which it is based, namely the perception of a market mood and the prediction of the behavior of other players. On the contrary, its supporters see technical analysis as a test of corroboration, the means of confirming or denying a vague and elusive impression.

The second element of plasticity is that technical analysis often proposes several scenarios. Either the price reaches this level and it will do this, or it reaches this other level and it will do that. These seemingly contradictory predictions make it possible to place a multitude of *stop-loss* orders at different levels and not be caught off guard when, as is often the case, the main scenario is invalidated by the price's behavior. The alternative scenario is available both to cut losses and to turn your position in the market from a "losing streak" to a "winning streak".

This flexible technique allows you to learn to practice the canons of *trading* and market discipline: "cut your losses and let your gains run". Thus, the invalidation scenarios make it possible to limit risk-taking and to focus traders not on past missed gains but on future gains. More than other methods, technical analysis immerses the trader "in the market" and its activity. It takes him out of the irresolute framework offered by the theory of efficient markets – up or down? –. It avoids locking him into the dogmatism of fundamental analysis, which leads to trying to be right, *in the end,* against the market and to waiting (sometimes for a long time) for the latter to realize its error of assessment, at the risk – as the chartists who maintain that "everything is in the prices" point out – of realizing that the market was already integrating economic evolutions that were then invisible in the "fundamentals" published from time to time by companies and administrations.

Self-referentiality or training

The self-referentiality of technical analysis is an argument often given by opponents to explain the – bad – reasons for the relative success of some of its

predictions. If everyone believes that when the price crosses a 20-day moving average on the downside, it is a downside signal, then the phenomenon would come true even if the signal had no validity prior to its formulation. This would be an example of the self-fulfilling prophecies described by Merton [1948]. This argument, known in the markets, is often advanced [Godechot, 2001, p. 223].

The idea of the self-referential effectiveness of technical analysis is, however, rejected by many adherents. Murphy notes that one can hardly castigate both the subjectivity and self-referentiality of technical analysis [2003, p. 16-19]. During the debate, Bompoint asserts that self-referentiality, far from realizing the prediction, can on the contrary destroy it. Indeed, if everyone believes, from reading the box, that the first rebound on the 22.35 mark will lead the price to 23.85, this will in a certain sense realize the scenario but distort it considerably. We will witness an *overshooting* phenomenon with an instantaneous jump of the price from the first level (as soon as the first stock is traded at 22.35) to the second level without any intermediate transaction. It would then be impossible to take advantage of it. The self-referential potential depends on the prediction techniques: we are not always in the case of sunspots [Blanchard and Watson, 1984]. Some may resemble them from afar, such as the crossing of the price and its 20-day moving average. But even in this case, one has to take into account the anticipations of some people who will use the 19-day moving average, then the 18-day moving average, *etc.,* in order to better profit from the movement, so that the final effect may differ from the one predicted. *In the end,* self-referentiality threatens all financial strategies, whether they are fundamentalist, chartist or mathematical arbitrage. If everyone is a fundamentalist, as the theory of efficient markets assumes, prices reflect fundamental value and there is no longer any gain in identifying over- or undervalued securities.

"Debates about financial strategies do not end like scientific debates with the triumph of one view over another. Strategic diversity is necessary."

For *traders* who engage in mathematical arbitrage or statistical *trading*, it is thus important to maintain secrecy about methods and to take advantage of trading offers made by competitors with different designs. Certain remunerative price anomalies such as the year-end effect disappeared when they became common knowledge [MacKenzie, 2006, p. 99]. The diversity and plurality of actors and beliefs are therefore necessary conditions for the success of a financial strategy. At the same time, in some cases, a bit of self-referentiality or, more precisely, a capacity to lead plays a crucial role. Thus, the LTCM fund ["*A brief history of LTCM"*, p. **157**] went bankrupt in 1998 because it was unable to "hold" long

enough an arbitrage that actually proved successful six months later [MacKenzie, 2003].

Financial actors are distinguished by the strategies and calculations they implement. It is less a question of them imposing their strategy completely on other actors (which would be dangerous and counterproductive) than of drawing actors with different conceptions into the wake of the evolution they foresee. Thus, the idea of a totally self-referential market [Orléan, 2000], in which everyone seeks to anticipate, simultaneously and similarly, what everyone else is doing, remains an illusion.

Conceptual and social diversities

Debates on financial strategies do not therefore end like scientific debates with the triumph of one conception over another. Strategic diversity is necessary. Periods of tension in which the various actors argue and criticize each other to gain symbolic credit, which is useful for the conduct of financial affairs, are followed by periods of relativism. "To each his or her own style". It is up to each person to find the method that is most in keeping with his or her taste for risk, his or her way of thinking, and his or her sensitivity. There is more agreement on the discipline of *trading*: have a plan and follow it, cut your losses, don't give in to emotions, respect the market, stay humble.

The terms of the debate are therefore rooted in personal stories and trajectories. There are enthusiasts, skeptics, disillusioned people and converts. The chartist analyst described in *Les traders* [Godechot, 2001], whom we met three years after the survey, had condemned the methods he taught in his room and, having become a *trader*, devoted himself solely to mathematical arbitrage. On the contrary, the founder of derivatives *trading* at Société Générale in the 1980s, a technique closely linked to the theory of efficient markets, sought with the faith of a convert to develop methods in a small *hedge fund* that combined options and technical analysis[3]. Behind this proliferation, one can nevertheless find some constants. In *The Traders,* we noted that the adoption of financial strategies was the product of likes and dislikes structured by a family, school and financial trajectory. In a trading room oriented towards the production and marketing of sophisticated products, mathematical arbitrage was adopted by engineers who had graduated from top schools and inherited a high level of cultural capital; fundamental economic analysis - which was not widely used - was adopted by people from higher social backgrounds but who were more economically

3 . The change of methods in financial markets has been taken into account by economic theory since the work of De Long *et al* [1990]. The conversions observed, however, are not only in terms of observing the incomes of practitioners from other groups (although this element is of course relevant) but involve a whole series of factors relating to the identity of the participants.

minded, while technical analysis was practiced by people from more modest backgrounds and with lower educational qualifications. This social polarization of financial strategies was illustrated in the round-table discussion. The rather popular *ethos of* Bompoint, a jovial and round man, quick to be anti-intellectual ("we're not very smart!"), contrasts with the more aristocratic ethos of Sainte-Croix, tall, slim, distant, with distinguished clothes and responsible remarks.

Technical analysis offers a practical framework for being in the market, disciplining oneself, making decisions, and focusing on short-term gain, which, while requiring practice, is both relatively simple and easy to understand. This art tends to attract relatively less endowed people, which also contributes to its relative symbolic devaluation. Although present at the highest levels of financial institutions, technical analysis still struggles to establish its legitimacy.

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