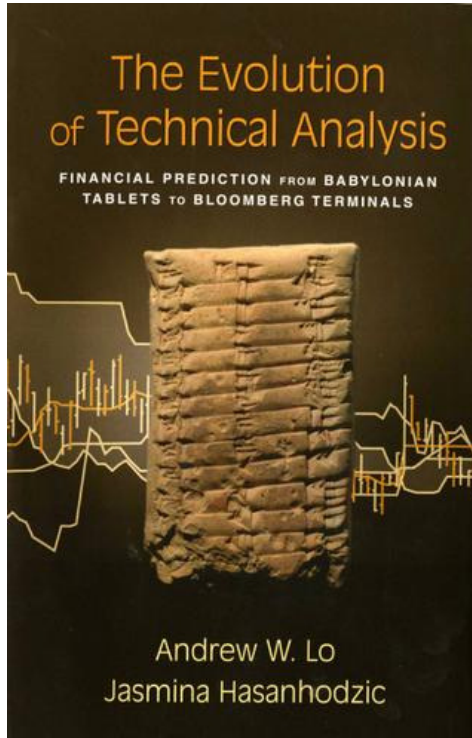


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Ancient roots of technical analysis

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'The Evolution of Technical Analysis: Financial prediction from Babylonian tablets to Bloomberg terminals' by Andrew W. Lo and Jasmina Hasanhodzic. Photo: Special Arrangement

After languishing for long in the murky waters of part art and part science, technical analysis is finally starting to develop a more rigorous foundation, write Andrew W. Lo and Jasmina Hasanhodzic in *'The Evolution of Technical Analysis: Financial prediction from Babylonian tablets to Bloomberg terminals'* (www.wiley.com).

The authors are of the view that the fortress walls separating technicians from the adherents of modern finance are not insurmountable though still standing tall. And that the recognition of the thousands-of-years-long legacy of technical analysis and the role it has played in shaping the behavioural theory of financial markets will awaken some of the sceptics and open the door for a more constructive dialogue between the two communities.

Black sheep in modern economics

Interestingly, the intro begins with a confession – that technical analysis, the forecasting of prices based on patterns in past market data, is something of a black sheep in modern economics. “Some sceptics view it as kissing cousins with sleazy speculation or gambling, while others regard it as a relic that is only slightly more sophisticated than the reading of chicken entrails.”

Conceding that some of the disbelief is understandable in light of the historical origins and occasional abuses of technical analysis, the authors add that many of its terms and concepts may seem abstruse or outmoded. “It is easy to see how a discipline that involves eyeballing charts for patterns with names like ‘head and shoulders’ and ‘cup with a handle’ might seem at first blush more akin to astrology than science.”

However, many of these are merely heuristics developed in the pre-computer age when calculating a simple statistic was a formidable task, the authors reason. They mention, as example, how the 10-day moving average became a fixture of technical analysis not because it was optimal, but because it was trivially easy to compute.

Babylon, Greece

Exploring the ancient roots of technical analysis – that is, the use of past prices to forecast future ones – the authors find evidence in thousands of documents from Assyrian trading stations in Anatolia with record of price fluctuations. “For example, one trader reporting about the high price of Babylonian textiles states, ‘if it is possible to make a purchase which allows you a profit, we will buy for you.’ Evidence from the third millennium BC suggests that prices of barley fluctuated widely.”

In ancient Greece, speculation was popular, and that led to the development of technical analysis methods, one learns. Athenian merchants knew that information was crucial, and they certainly knew the value of geographical and environmental information, such as trading routes, hazards along the way, and winds, the authors inform. “For this purpose merchants devised their own manuals, such as the *Periplus Maris Erythraei*, which provided information about the products sold in countries along the route to India and the attitudes of their rulers.”

Japan, China

A chapter on Asia chronicles the development of technical analysis by Munehisa Homma (1724-1803), considered the ‘god of the markets’ in Japan. Homma’s writings are treasured by traders and historians alike, not only for their wisdom, but also because they represent rare documentation of early Japanese technical analysis, the authors observe. “When all are bearish, there is cause for prices to rise. When everyone is bullish, there is cause for the price to fall,” is a snatch of Homma-speak.

In the ‘China’ section of the chapter, there are nuggets of insight such as that the Chinese merchants operated on the belief that the market ‘was not a mysterious force beyond control’ but one that could be ‘understood, mastered, and manipulated.’ Among the widely used manuals in China was *The Merchant’s Guide* (*Shanggu bianlan*) compiled by Wu Zhongfu in 1792, which advised its readers to write letters so that they can know the ‘flow of goods everywhere’ and thereby ‘know the information and opportunities in time and know what to do and what not to do...’

Educative reference for avid students of markets.

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