Using Technical Indicators on Hedge Funds

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Hedge funds were developed in the late 1940s as a means of giving financially savvy investors more control over their investments by allowing them to leverage pooled funds through a limited partnership that gages risk against growth in an attempt of reducing losses. Contrary to commonly accepted understanding, hedge fund managers often seek to leverage risk rather than avoid it, altogether. Or rather, they attempt to ensure that any losses acquired remain at a minimum. Of course, such is always the goal with investments, but with the case of hedge funds most managers attempt to earn positive returns regardless as to whether equity prices are positive or negative to their respective positions.

Perhaps the most established means of hedging against loss that managers use incorporates short selling, or what some refer to as a long/short equity strategy. Such a strategy is implemented when a manager maintains long and short positions in equity along with, say, equity derivatives. As such, managers often have a hedge against losses, at least to an extent.

In so doing, many, if not most, fund managers rely on more traditional means of projecting returns, the tried-and-true method of using technical indicators, or what we simply refer to as "technical guessing." Managers use technical indicators for projecting stock prices; for example, for guessing as to whether a stock will rise or fall and to what extent. Such seems to be the case throughout the business and financial world today—using guessing couched as a technical or analytical method rather than applying statistics, econometrics, or probability as sound methods for decision making.

Consider simple moving averages (SMA) or Bollinger Bands as examples of technical indicators. Moving averages and Bollinger Bands both are defined by historical data with no effort taken to estimate potential future price. Simple moving averages rely on the mean stock price from the previous 20 days or so, while Bollinger Bands rely on those same days but are plotted as moving standard deviations, usually at +/- 2SD, of the SMA.

As with simple moving averages, Bollinger Bands allow no effort to be taken toward projecting potential future price. One can use these techniques to guess, however. But guessing is hardly a sound means of managing millions or billions of dollars. That said, simple moving averages, Bollinger Bands, and other technical indicators have their place in trading, but these techniques merely serve as indicators, not as rigorous means of making decisions regarding stock price, or company value for that matter.

Earning strong returns is difficult at best, regardless of the market. During bear markets strong returns are difficult, and during bull markets strong returns are difficult. But maintaining a laisse fair attitude toward money management is not one most investors accept. Fortunately, economists, mathematicians, statisticians, and others have developed rigorous methods for forecasting stock price—as well as a host of other variables.

At a minimum, hedge fund managers should couple technical indicators with statistics, econometrics, and probability for projecting price and ROI, especially when incorporating high volume trading techniques into the trading mix. That said, the same techniques should be considered when using low volume trading techniques, or even when using a temporary buy-and-hold technique. Until then, technical indicators remain a guessing game without scientific merit—a pseudo-science.

Robin H Barber, MBA, CPA is Partner & Chief Financial Officer of Xicon Economics, LLC. She has provided advisory, consulting, and management of large capital initiatives in the private sector for over 30 years. Robin's expertise lies in financial analysis, risk analysis, tax and cost accounting, decision modeling, regulatory compliance, financial portfolio development, and financial management of large capital investments.

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