

# Foundational Analysis

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**I** like to use the analogy of the human body—in a purely physical sense—to describe your needs as an investor/trader (I/T). Just as your body needs quality food to survive and thrive, you need quality information to build and maintain healthy investments. Most “market food” has already been digested by the market (reflected in price) before the average person gets it. Like any other digested food, it no longer has nutritional value. People get market information from the media only after its value has been exhausted. The question is, why then do so many people still rely on this information to make decisions?

On our journey, we will hunt for quality information that is still nutritious and full of value so that our investments can flourish from it before its value is digested. This information will not come from the media reports, which are based on news from brokerage firms and corporations. Too many people are enamored with these reports, which is why most participants lose their money in the market. Our food comes from the art of tracking market psychology in the form of greed and fear. This is where you will find the best market food.

The difficult lesson to convey here is that those who have brilliant success in the stock market employ the simplest methods. Indeed, it is the shock market’s simplicity that is its greatest disguise. For, in the end, what causes stocks to go up and down is not some diabolical force that lies beyond human intelligence, but instead the interaction of basic emotions. It is only when we learn to distance our emotions from market analysis that

we begin to understand the fundamental simplicity of the stock market and to trust that, at any level, the game is neither mysterious nor unbeatable.

In this chapter, I describe specific tools that you can use to simplify reading the stock market's vital signs. These tools all fall within the rubric of *foundational analysis*, a discipline that uses only a few variables to fully reveal the essence of stock-price fluctuations. The four key variables of foundational analysis are *price*, *volume*, *time*, and *velocity*. In combination, they can tell us nearly all we need to know to profit as traders. Including more variables will only complicate the task by increasing our bias and making us susceptible to subjective factors as well as to emotional swings.

Emotions are a trader's worst enemy. The skills that you must learn to succeed can develop only when you focus on what is real and available in the market and ignore the extraneous, mystical, and subjective. In this book, I discuss ways to quantify such observations using foundational variables, but you must first be aware that knowledge of these variables cannot ensure successful trading, for no trading signal works all the time. Diligent traders monitor real-time market data derived from price, volume, time, and velocity, as well as from historical trends; but they do not apply this data in the same way with every trade, since the markets are constantly changing. Thus, mastery of the stock market is more of an art than a science.

The array of information at our disposal can be bewildering: Pictograms, heat maps, histograms, and oscillators produce a never-ending stream of bullish and bearish signals. But all of it is useless unless you incorporate sound principles of risk management as well as a perspective that wisely takes the past into account. Even then, the most valuable tool—experience—is something that can only come with time. Books or seminars cannot fully explain or replicate experience, no matter how thorough the curriculum. As a trader, you should rely on *Ordinary People, Extraordinary Profits* for valuable guidance, while interpreting the material in terms of your own experience.

You should view foundational analysis as a tool to structure and organize your market observations so that you can apply them systematically toward the goal of profitable trading. As you read this book, keep in mind that you want to learn and hone a systematic approach to the market, not to perfect a trading system per se. As you absorb the lessons of the various chapters, the differences will become apparent, but in practical terms this approach means that you will be seeking to develop an edge over other traders rather than a guaranteed lock on profits. Holding an edge requires learning from others who are successful, keeping an open mind, and never succumbing to the belief that any one method or technique will work forever.

Because the markets never stop mutating, the best traders know that the only thing that works over time is to constantly embrace change. How

we made money yesterday is not always going to be the same way we will make money today or tomorrow. Many traders learned this the hard way when the raging bull market of the late 1990s abruptly turned into a hostile bear market. Not only did the temper of the market change, but the rules changed as well, including a move to decimal prices. This action tightened spreads between bids and offers, effectively eliminating a successful arbitrage tactic of easier money. What did not change when the bear market came marauding in March of 2000 were the foundational variables with which we interpret the market's underlying dynamics. To understand this is to survive. Our steadfastness in adhering to bedrock principles of the market is why we have endured long enough to share with you the means for duplicating our success.

It takes discipline and courage to confront the psychological challenges that the stock market throws before you each day. In the end, the market is all about the unknown—what we might call the far-right edge of the chart. This is an undeniable truth. The far-right edge could be applied to life itself. Every time you get in your car, you do not know if you will have a good day or a bad day. So on any given day, you cannot know in advance if the market is going to go with you or against you. That is the reality of life. Harsh? Probably. Realistic? Absolutely.

Trading is about gaining whatever small edge exists to predict the very near-term future. This concept builds on common sense, and applying it to the market relies on the principle that the most recent past will have the greatest influence on the near-term future. The further you try to project a trend out into the future, the farther back in time you must look.

## CHARTS

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Before examining the key components of foundational analysis, it is necessary to understand the charts that are used to record price, time, volume and velocity. The dedicated chartist will say that all the information needed to predict what a stock will do is contained in charts showing what the stock has already done. Some might scoff at this claim, but charts are the best indicator of what a stock is about to do and what it has just done. Before exploring why this is so, we are going to look at several types of charts that appear in this book. Figure 1.1 is a simple bar chart.

In Figure 1.2 we examine just a piece of the chart in Figure 1.1 under a magnifying glass. Notice that these bars are not simple sticks, but they have tiny tick marks protruding from their sides. The tick mark on the left side indicates the opening price; the one on the right side shows the closing price. The high point of the bar is the highest price that was traded



**FIGURE 1.1** The price activity of a particular stock over a period of five months, from October to February. Time is shown on the horizontal axis, with monthly intervals noted at the bottom. The vertical axis shows price. In this example, the stock has fluctuated from a low of about \$18 in early October to a high just above \$45 in mid-February. There are many facts on the chart in which we could also say the stock fluctuated between \$30 and \$35 between late November and early January. We could also say that the stock rallied steeply between mid-January and February. This last statement relates to velocity, one of our four key foundational variables.

during that particular period and the low point is the lowest price traded within the period.

Analyzing a stock on a chart should not be limited to just one dimension of time; rather, we combine multiple time frames to gain further clarity about the stocks' behavior. It is common to begin our analysis with a study of daily data (Figure 1.1) and then magnify that period of time by use of an intraday time frame (Figure 1.2). The shorter-term time frame allows us to get more precise in our entry orders as well as to manage the trade with carefully placed exit orders.



**FIGURE 1.2** This intraday chart shows a more detailed view of the last 14 days in Figure 1.1. Vertical lines separate the data into two-day increments of time.

Figure 1.3 shows the chart of a stock with the foundational variable of volume displayed beneath it. Volume shows how many shares of a stock have traded hands for a particular period.

Thus, we can summarize a stock’s price history merely by glancing at its chart. In the preceding examples, price, time, and volume are all explicit whereas the remaining foundational variable, velocity, must be inferred. The quantification of velocity is discussed later in this chapter, but for now simply think of velocity as the rate at which a stock’s price changes over a given interval.

Another type of chart that offers an especially concise summary of a stock’s price history is called a *candlestick* chart (see Figure 1.4). Here the XYZ chart is rendered with price represented in candlestick form. The bars are shaped like wax tapers, and most have “wicks” sticking out of the top and the bottom. Candlestick charts date back to seventeenth-century Japan, where a rice broker named Munehisa Homma is said to have been

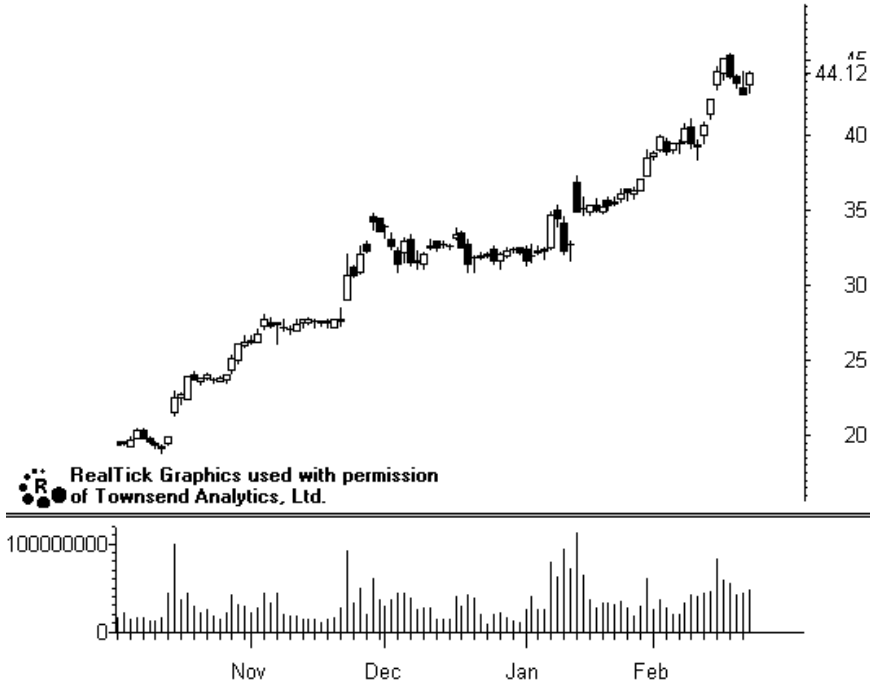


**FIGURE 1.3** Nearly identical to Figure 1.2, this chart also contains volume bars that tell us how many shares of XYZ stock traded for each intraday period.

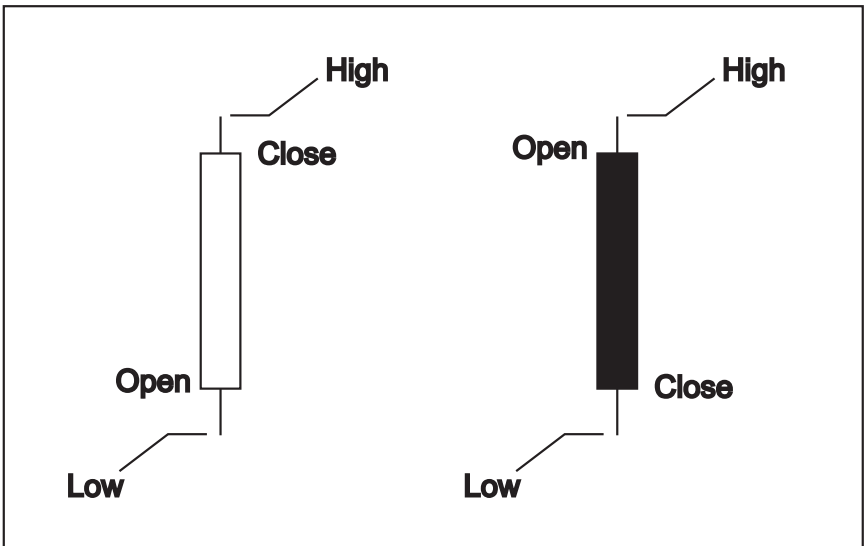
one the first traders to use price history to predict price future. His theories and rules form the basis of the candlestick charting methods in use today. In Figure 1.4, each candlestick represents a single day's price action, with open, high, low, and closing all noted.

The highs and lows are intuitively obvious because they are marked, respectively, by the tops and bottoms of each wick, or shadow. For instance, if you look closely at the spike higher near mid-January, you will see that the candlestick bar's shadows extend from approximately 35 to 37. That was the stock's price range on that day. But also observe that the "bodies" of some candlesticks are clear (they would be green if shown in color) whereas others are black (or red, if in color). The detailed diagram in Figure 1.5 summarizes the basic candlestick. If the rectangle or real body is clear (or green), the stock closed *above* its opening price. When the real body is black (or red), the stock closed *below* its opening price. If the body does not exist, it means the stock opened and closed at the same price, even though it may have traded over a wider range for the period being measured.

Daily **XYZ Corp**



**FIGURE 1.4** The same information as the daily chart in Figure 1.1, but the open, high, low, and close are shown as candlesticks.



**FIGURE 1.5** The white candles indicate a period of time where the stock closed above the price it opened during the period. The dark candles show a period where the close was below the open. When illustrated in color we could expect green and red respectively.

An advantageous aspect of candlesticks is that they tell us at a glance whether the close was positive or negative. Also, those of us who stare at charts for hours at a time find candlesticks are easy on the eyes.

## **TWO TYPES OF ANALYSIS**

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Now that you have a basic understanding of price charts, you need to decide how to analyze them. Active traders must have a method for deciding when to enter trades and, more importantly, when to exit them. How do you plan to do that? When will you know a stock, index, option, or futures contract is at a specific price or a price level that provides an acceptable risk-to-reward ratio? Once in a trade, how will you know when the trade is working for you, when it is not working, or when you should exit because the risk-reward ratio is no longer in your favor? As an active trader, you must have a system that allows you to react quickly, not one that requires extensive fundamental research.

On the broadest level, you only have two choices: fundamental or technical analysis. Most traders who come from a background that emphasizes investing for the long-term are familiar with fundamental analysis. In its most basic form, it uses earnings per share of a stock to evaluate whether the stock is a buy (undervalued) or a sell (overvalued). In reality, the analyst may examine all the information that is fundamental to the entity (stock, commodity, etc.) to evaluate the chances that it will gain or lose value. The fundamentals for a stock include any factors that will help or hurt the company's chances of making money: actual and projected earnings, market share, product sales performance, management expertise, industry performance, micro- and macroeconomic outlook, government regulations, news, public relations announcements, and so on.

For physical commodities like corn or silver, the fundamental analysis is often oriented to actual supply-and-demand data. The fundamental analyst wants to know how much of the commodity is left over from previous years (carryover), how much is in the supply line (storage), and how much will be produced (grown, mined, refined, etc.) in the near-term, mid-term, and long-term. Then they look at demand, usually worldwide, for that commodity. Is it strong or weak? Is the world overflowing in that commodity or is it scarce? What and where are the stocks. Does any event loom on the horizon (e.g., drought, war) that would affect supply or demand? The analyst needs to know whether the price of the commodity being evaluated is elastic or inelastic: How responsive is the price to changes in supply and demand? Will demand dry up for a commodity if the price gets too high? Do chocolate addicts worry about the price of cocoa when supplies tighten

and prices soar? Not likely. But will cattle feeders switch from feeding corn to feeding wheat if wheat is substantially cheaper than corn? Yes—thus the difference between elastic and inelastic.

Finding, gathering, analyzing, and evaluating all the fundamental factors influencing the price of a stock or other entity takes time and is often subjective. Likewise, many of these factors take a long time to show their impact. Negative news or a poor earnings report could knock \$10 off the per share price of a stock. Nevertheless, investors may know that the company behind that stock is fundamentally sound—well run, progressive, and a good buy for the long-term. If they are planning on holding the stock for months, quarters, or even years, it is probably a good buy at the depressed price.

But as a trader, should you buy? Traders think short-term; they buy and sell over a period of several weeks, days, and even hours and minutes. Traders think income; the objective of investors is building wealth. The income from trading may be used to create the wealth. The only interest traders may have in the stock in question is to sell the stock short if it continues to show weakness, or to reverse and go long when the stock shows signs of strength again.

If you come to trading from an investing background, you need to make a substantial mental adjustment. Traders live in the here and now, not the future. Where a day means almost nothing to a long-term investor, it can be the entire lifetime of a trade. For some traders, it could easily be the lifetime of 5, 10, 25, 50, or more in a single day. Executing dozens of trades a day is common for active traders. There have been times when the markets were as hot as a summer in Phoenix and traders racked up a hundred or more trades a day, but this is not our focus.

Active traders generally do not depend on fundamental analysis on a daily basis for selecting stocks and picking entry and exit points. It simply takes too long to do the analysis or to wait for major price-influencers to take hold. Instead, active traders like to do what they call “keeping the wind at their back.” They want to look at the fundamentals to learn the overall trend. They feel more comfortable trading from the long side in bull markets and from the short side when the bear rules, particularly if the trend is strong.

Deep fundamental analysis has another drawback for the active trader; it is not self-correcting. If a stock appears to be a good buy at \$20 per share based on fundamental analysis, it must look twice as good at \$10. Obviously, if you purchased 1000 shares at \$20 and it is now \$10, it might not seem to be such a good idea.

Technical analysis solves these problems. It can quickly alert traders to opportunities, it marks specific entry and exit price levels, and corrects itself when it is wrong. This last capability may be its most important

characteristic—the difference between a long and successful career as a trader and a short and unhappy one.

There are only five possible outcomes for any trade. It can be a big winner or loser, a small winner or loser, or break even. You can survive with any of these outcomes except being a big loser. Winners are always welcome, whatever the size. Losers are inevitable. They are as common to active traders as strikeouts are to major league baseball players. Ballplayers who can't deal with striking out or traders who become depressed by repeated losses are doomed to the bush league. Worse yet, those who don't learn to avoid big losses get thrown out of the game altogether.

Technical analysis is an ideal tool for the active trader, but it is no panacea. You can go broke using technical analysis just as you can with any trading or investing system. Its greatest strength—its ability to self-correct—also can be its most frustrating feature. When you set up a trade using most any type of technical analysis, one of the key elements is selecting a price point that confirms the trade is *not* working. This is known as the *stop-loss* price. Let's say the stock you are trading is in an uptrend. You decide to stay in that trade until the stock breaks through the uptrend line drawn on a price chart by connecting all the closing prices. Once the trend is broken, you close the trade.

Trading the uptrend and exiting when it is broken is a legitimate trading approach that self-corrects. But what if, as soon as the trend is broken and you exit the trade, the price of the stock reverses again and heads higher? You exited too early and missed some additional profit, or even lost money. This is known as being *whipsawed* by the market. Although it can be frustrating, it is a part of trading you must accept and avoid losing discipline over. The worst thing you can do is to start second-guessing your stop-loss level by arbitrarily staying in some trades and exiting others when they hit your stop-loss price. This is how to set yourself up for a major loss.

If used properly, technical analysis prevents major losses and provides a framework for selecting trades with acceptable risk-reward ratios.

## **WHAT EXACTLY IS TECHNICAL ANALYSIS?**

Technical analysis is a method of evaluating stocks, futures contracts, options, and other securities. It relies on the assumption that market data, such as price, volume, volatility, open interest, and other quantitative facts, can be used separately or in combination to predict future (usually short-term) price movements or trends. Unlike fundamental analysts, technical analysts do not even consider the intrinsic value of the entity being evaluated. They believe that they can accurately predict the future price movement by looking at its

historical price activity and related statistics. They assume market psychology is reflected in the technical data allowing them to anticipate when an entity's price will rise or fall and when price movement or trends will start, stall, or reverse. Many technical analysts tend to be market timers, who believe that technical analysis can be applied to the market as a whole—to market sectors, indexes, and individual stocks, futures contracts, or options.

Literally thousands of technical studies are available. Some are simple and straightforward; others are complicated and esoteric. Here is a short list of subjects of well-known studies:

- Advance/decline line
- Moving average
- Point-and-figure charts
- Resistance and support
- Descending tops and bottoms
- Breath-of-market theory
- Breakouts and breakdowns
- Price chart formations—cup and handle, saucer, flag, pennant, double bottom, head and shoulders, and double tops
- Elliott wave theory
- High-low index
- Momentum indicator
- MACD
- On-balance volume
- Overbought/oversold indicators
- Tape reading
- Relative strength
- Arms index
- Bollinger bands
- Stochastics
- TRIN
- Turnover ratio
- Volatility index
- Regression analysis
- Money flow
- ADX

Technical analysis is a smorgasbord. It is a giant feast, set for anyone hungry for ideas, information, and an edge on the market. The problem is that there is often too much to enjoy, and too many traders want to start at the dessert-end of the table. They want the softest, gooiest, sweetest, and easiest trade first. In other words, just pass them a technical system that is foolproof and 100 percent effective. Junk food for the mind.

Such a system does not exist. If it did, would any of us be reading (or writing) this book? The next thing to understand is that technical analysis uses both art and science. The latter part occurs when the technician develops the quantitative part of the trading system. All the commonly used methods are computerized on trading platforms (e.g., RealTick®), making it simpler to get started. Visit [www.realtick.com](http://www.realtick.com) for more information.

The former part, the art of technical analysis, refers to the trader's interpretation of the data or signals that the system generates. When is a signal a signal? This may sound strange now, but once you begin to trade you will understand exactly what I am saying here. For example, you are set to enter a long position when a certain price is hit, but what do you do if that price is immediately exceeded by a few pennies or is hit and immediately retraces? Do you go long or wait? What if volume spikes or flat lines at the same time? What if extremely good or bad news, or a rumor, sweeps the trading pits? Even the best technical systems cannot take all the market fluctuations into consideration. You, as a trader, must often make a decision with conflicting or imperfect information.

The art of trading evolves from experience. You cannot learn to trade without trading. For this reason, I recommend that you start out small, trading a hundred or so shares using a simple system. The objective is to learn how to execute good trades. Is a good trade one that makes money? Often it is, but not exclusively. A good trade is one in which you have absolute control and you exercise that control with ironclad discipline. You may lose some money, but you do it on your own terms, not at the whim of the market. Or it could be a trade that you exited based on your system, but too early—leaving money on the table. You don't want to do that on a regular basis, but you do always want to be in control. You pick the trade. You enter it at your price. You exit at your price or at your stop-loss limit. You are calling the shots. Even if a call results in a loss, you are acting on the market, rather than reacting to the market's gyrations. Acquiring the control that you want to get from the use of technical analysis is neither easy nor automatic; it requires cool headedness and discipline. Nevertheless, making every trade a perfect trade is your goal.

You may have a trading system that you feel fits the criteria I have described. If not, this book provides a simple and reliable one. Once you master it, you will probably begin to modify it to better suit your needs and personality (this is the art of trading coming to the surface). Before going any further, it is useful to learn how and why technical analysis works.

Four foundations or principles support technical analysis. The first is *market action discounts everything*. This means that everything known to the market is reflected in the current price. Stocks trade for what they are worth and the current price reflects all the supply and demand factors. Some market participants get news and act on it before the general public

can do so, but astute technicians can spot this activity by monitoring charts and volume data. Recognizing what traders are doing doesn't tell us why they are doing what they are doing.

A chart illustrates what all the participants are doing. It represents the collective psychology of thousands of decision makers. The stock market is known as a discounting mechanism because it attempts to factor future events into current prices. It is important to recognize that decisions to buy and sell stocks are often based on what is expected to happen. Much of what moves stock prices is the anticipation of future events. It is here that fundamental analysis plays a role in the development of long-term trends. Because perceptions about the worth of a stock continually change, prices are in flux. The catalyst for a change in perception is often a fundamental development, but technical events can also lead to a move higher or lower, especially in the short-term time frames that are so important to active traders.

*Price moves in trends* is the second principle of technical analysis. A trend once established is more likely to continue than reverse, Sir Isaac Newton's First Law of Motion states: Every object in a state of uniform motion tends to remain in that state of motion unless an external force is applied to it.

Stocks are no exception to this rule. A stock that is moving higher continues to do so until it reaches a level that motivates sellers, an external force, to offer enough stock to overwhelm the buyers, thus halting an advance. Stated in another way, as long as demand exceeds supply, prices rise. That only makes sense because publicly traded securities represent the largest auction markets in the world, and all markets are ruled by the basic laws of supply and demand.

Likewise, a stock will continue to drop in price until the perception of value has changed enough to motivate buyers to overcome the supply of stock being offered by the sellers, thus halting a decline. Simply stated, as long as supply exceeds demand, prices drop. It is important to point out the use of the word *perception*, because the markets move based on perception, not necessarily on fact, common sense, or even fundamentals.

It is said that the collective intelligence of the market sinks to the level of the least informed participant. That is a scary thought, but understanding it allows you to put your feelings aside and observe market action on its own merits, rather than on what may appear to be the logical scenario.

The third principle of technical analysis is *history repeats itself*. An often-repeated phrase goes something like this: "Those who forget the past are condemned to repeat it." A study of previous market action provides significant insight into the way it trades. There is no doubt that certain patterns repeat themselves on different charts at different times. These patterns merely reflect the sum of the hopes, fears, and expectations of all

market participants. Because people are often emotional decision makers, they tend to react to certain events in predictable ways, especially when it comes to investing in the stock market. These emotions are the only true constant in the perpetually changing market mechanism. By understanding human psychology and what motivates the buy and sell decisions, you can often position yourself ahead of the action and anticipate profitable trade setups. When you are looking at a chart, keep in mind that you are actually looking at the collective psychology of the market participants.

The final principle of technical analysis is *always have a backup plan*. Trading is an art, not an exact science, and your analysis will not always be on target. Put harshly, the market does not care what you think. Your opinion as a trader does not count, unless it is correct. When the final bell rings, only the right votes count. Once you have done your analysis and come up with a plan of action for a trade, your work is just beginning. Successful traders know that they will be wrong many times, and they prepare for those situations with predetermined stop losses that help avoid large losses. If you can eliminate large losses, your account will be able to handle the unpleasant, but inevitable, string of small losses that most traders experience before hitting it big.

No one initiates a trade with the intent of losing money, but even the best traders do stupid trades occasionally. What separates the good traders from the excellent ones is the ability to take losses unemotionally at predetermined levels. These levels are based on time-proven money management strategies. A backup plan is part of an intelligent approach to trading that recognizes that no one is a perfect trader.

Now that we have discussed the four principles of technical analysis, let's explore how stocks are actually supposed to trade. Most traders have heard of the *Random Walk Theory*, which was made popular in Burton Makiel's book *The Random Character of Stock Market Prices* (1964). According to this theory based on stock prices trading randomly around their intrinsic value, the best strategy is simply to buy and hold stocks. Well, anyone who bought stocks based on this theory during the bear market of 2000 to 2003 and is still holding them today would likely disagree with the theory. There is a lot of randomness in the day-to-day movement of stock prices, but being able to recognize trends and developing a strategy for selling based on the discontinuation of a trend allows you to be in cash or to sell short during volatile and uncertain markets like those of 2000 through 2003. The Random Walk Theory also states that price movement is random and unpredictable. Although it is true that stock price movement cannot be accurately predicted all the time, it is also irrefutable that prices often move in trends. You will not always enter a stock at the right time so you must protect your capital through the intelligent employment of stop-loss orders. If you are going to have any faith in technical analysis, or even in trading, you need to forget the Random Walk Theory right now.

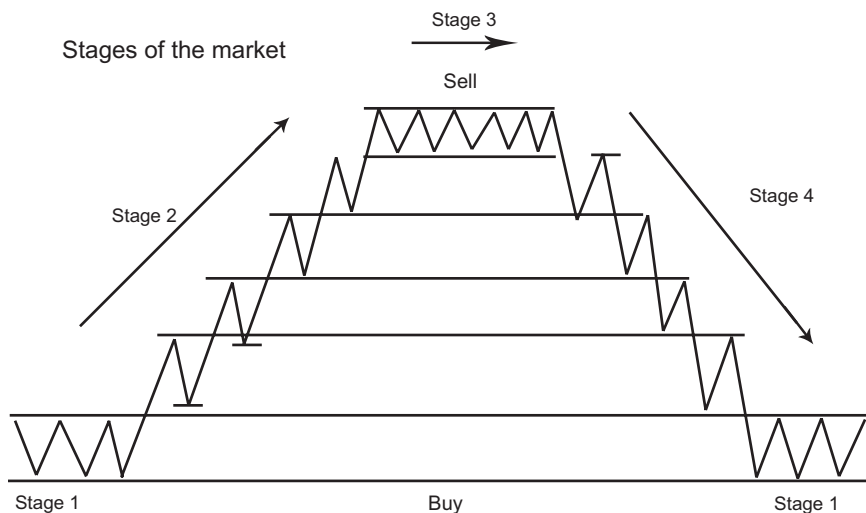
The only true constant in the market is that humans tend to act, react, and overact in similar ways to certain situations and this behavior repeats over and over in the market. This is why technical analysis has merit; you are merely looking at emotions reflected on a chart to gain insight into how the crowd may act in a future similar situation.

## THE FOUR-STAGE THEORY

Four distinct stages or phases govern the movement of stock prices:

1. Accumulation
2. Markup
3. Distribution
4. Decline

Each phase can be viewed and accurately interpreted on all time frames from 1-month charts all the way down to 1-minute charts (see Figure 1.6). For traders, it is important to make sure that the trend is the same on various time frames; you want the long-, intermediate-, and short-term trends to be sending the same message. Inconsistency among the time

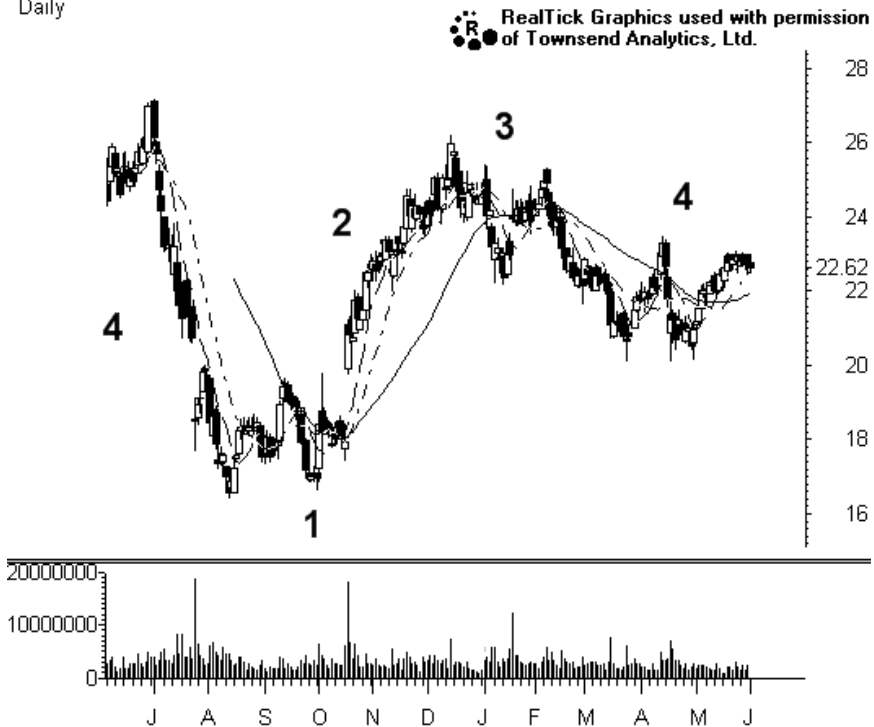


**FIGURE 1.6** This Illustration could represent the action of a stock over a 10-year time frame, a 1-year time frame, 45 days, 10 days, or even 30 minutes. Regardless of the time being studied, these cycles are repeated over and over. To understand what action to take in each of these stages, first we need to break down each stage.

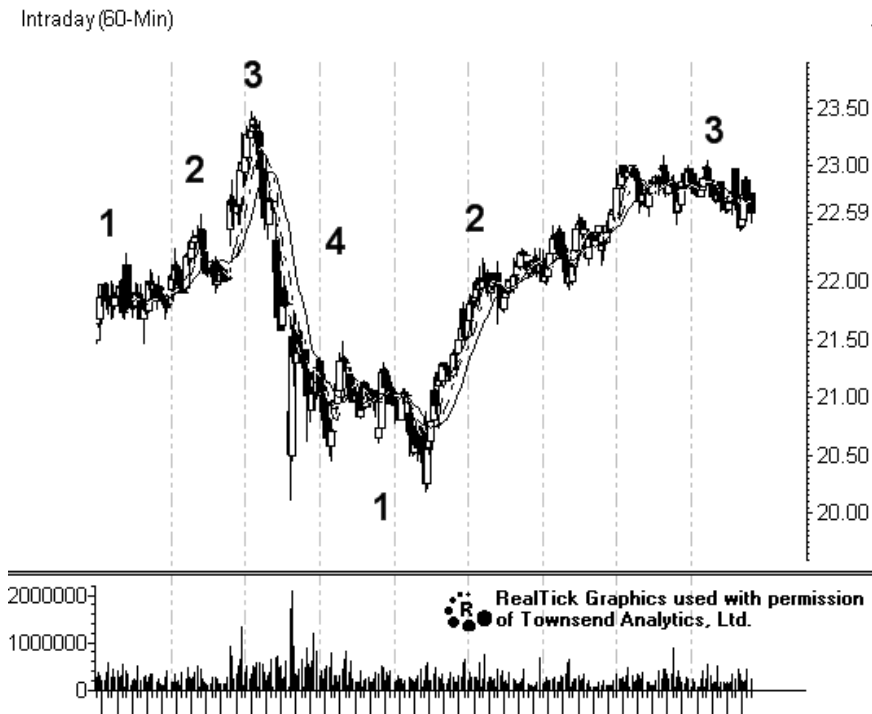
frames diminishes the probability of a winning trade. An alignment of a trend across time frames greatly increases the odds of a successful trade, provided, of course, that you make the proper entry and have a favorable risk-reward ratio.

In this book, three time frames—daily, 60-minute, and 10-minute—are covered for each security to ensure that the short-term trends are not in conflict with larger, more powerful, trends on long-term charts. These time frames are the ones we consider most important for swing trading decisions (1 to 10 days). This is an excellent way to find candidates for short-term price movement as opposed to looking solely at the short-term time frames to time day or swing trades. The daily chart (where each bar or candle represents one day of trading data) is the first time frame to examine to verify the overall trend and to determine its maturity (see Figure 1.7). This is also the time frame that our “Profiler” scanning technology uses consistently to find the best trading and investing ideas each day (see Figure 1.11).

Daily



**FIGURE 1.7** All four stages of stock movement for a given stock over the course of approximately one year. Each candle represents the trading activity for one day.



**FIGURE 1.8** Shares of the same stock as in Figure 1.7 on the hourly time frame, showing the four stages of a stocks’ life on the most meaningful time frame for swing traders.

The hourly chart (each candle represents 60 minutes of trading) is the next and probably the most important period for swing traders to study (see Figure 1.8). It is the time frame for planning the trade, which is based on a risk-reward ratio of at least 1:3. A 1:3 risk-reward ratio means that for every dollar at risk, there should be a potential to make three dollars. The risk reward ratio is best planned for on the hourly time frame because this is where we can most easily recognize important levels of support and resistance that form the trends. Having a favorable risk-reward ratio allows for the occasional small losses everyone experiences, while the winners will make up for those losses with less than a 50 percent win-loss ratio. When you eliminate the large losses, you can increase your probability of overall success.

For a closer look at the action, the 10-minute chart (each bar represents 10 minutes of trade data) should be studied next. On this time frame, you can become more detailed in your analysis and identify short-term levels of support and resistance. This allows you to manage risk with tight

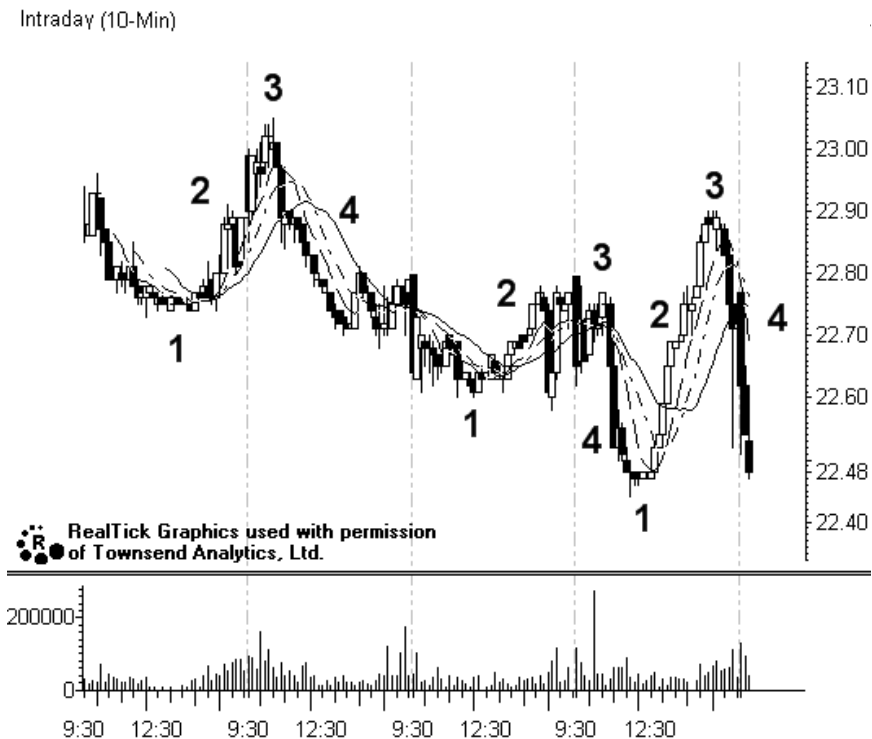
stop-loss levels within the context of the longer-term trend, where the profit potential can be significant (see Figure 1.9).

Using these three time frames together in a consistent, disciplined approach to trading lets you take advantage of short-term movements within the larger trends during all four stages of accumulation, markup, distribution, and decline.

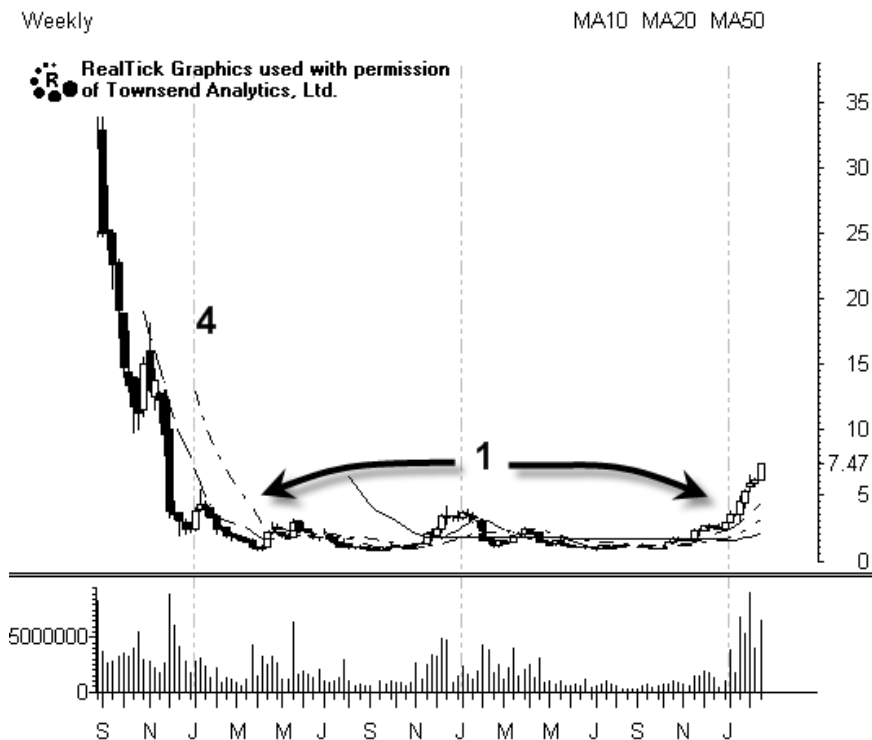
These four stages are found over and over for all stocks, regardless of the time frame. One of the keys to success in the market is to trade with the prevailing trend, which is why you purchase stocks in Stage 2: Markup; you sell short in Stage 4: Decline and you avoid trend less stocks in Stage 1: Accumulation or Stage 3: Distribution, when fluctuations tend to be small and trading opportunities are inconsistent.

### Stage 1: Accumulation

In Stage 1, bullish participants acquire stock in anticipation of higher prices, which will occur during Stage 2. These participants are able to ac-



**FIGURE 1.9** Moving down to an even shorter time frame allows you to observe how the four stages are repeated over and over for all securities. Your objective for time in a trade dictates which time frames to use to focus your cycle analysis.



**FIGURE 1.10** The Accumulation stage can sometimes last years; participating in these stocks can unnecessarily tie up your capital in a stagnant position.

cumulate shares of a stock without moving the price higher because this phase usually follows a large decline. There are still many sellers of the stock looking to reduce or eliminate positions. During this period, there is a fierce battle between the bullish buyers who are trying to establish a long position and the bearish sellers of the stock who are still getting out of positions they may have ridden down in price.

So who is doing all this accumulating? And who is selling them the stock? A Stage 1 stock is usually viewed as a major reversal pattern that can take up to a couple of months to complete on a daily chart. There usually isn't much downside risk in purchasing in this phase. The risk here is time. Your capital may be tied up in a stagnant position for months while other stocks could be experiencing powerful Stage 2 uptrends—this is opportunity cost. Why wait for the stock to move, when it could take months, if not years, before it is ready to go higher? (See Figure 1.10.) This is a time to stand aside and let other people do the dirty work of ridding sellers of their supply. The objective of short-term trading is to keep your money in the stocks that are moving *now*, and Stage 1 stocks do not advance that goal of

consistent profitability. The only time it may make sense to purchase a stock in this phase is if it pays a decent cash dividend; then you must rely on fundamental analysis to determine whether the dividend is safe.

Think of a large institution, mutual fund, or major retirement fund wanting to build a substantial position in a stock. A stock in this phase is the perfect opportunity to buy large (sometimes as much as tens of millions of shares) positions without moving the stock higher. Buying a stock during Stage 1 allows an institutional investor to minimize the market impact cost (the amount that their buying moves the stock higher). *Value players* (whose strategy is to buy stocks that trade for less than their intrinsic value) are some of the most patient people on the planet. They do all kinds of forward-looking fundamental analysis on an industry or company, and buy millions of shares from the less astute growth fund managers, who may have ridden the stock lower during its decline and believe they are holding damaged goods in their portfolios. There is a saying that warns, "If they don't scare you out, they'll wear you out!" It applies to all the people who rode a stock down waiting for "just one more rally" that never materialized. Now they are tired of seeing that stock on their statements because it reminds them how stupid they were not to sell earlier, so they sell at this point. This sale is known as moving the stock from "weak hands into strong hands."

The volume and moving averages (MAs) are of little value while a stock is in the actual healing process of back-and-forth action, but they can provide some clues as to when the stock may be ready to advance to Stage 2: Markup. The best time that volume can provide clues about the action to come is when a period of sustained high volume occurs after the stock has been trading in a tight range that may last up to nine months. This pick up in volume is often a sign that the buyers are getting more aggressive, which sets the stock up for the Markup phase and higher prices. Moving averages, discussed later in this chapter, are of little value for generating trading ideas while a market is not trending, and the price usually stays below the longer-term MAs during the healing process. Short-term MAs display a lot of back-and-forth action as the stock price rises above and falls back below these MAs, which give numerous and conflicting signals. After the stock has recovered for some time, the longer-term MAs will slowly begin to flatten out. Until the longer-term MA flattens out, purchases should be avoided and the stock should be considered "guilty until proven innocent."

The Profiler developed at MarketWise breaks down each of the four stages into three substages. Stage 1, for example, has these substages: 1-1 (early Accumulation), 1-2 (mid-Accumulation) and 1-2 (late Accumulation). This information is unique to the Profiler and has valuable uses. Suppose the overall market has been in the Accumulation phase for quite awhile and it suddenly breaks out to a strong uptrend (Stage 2-1). In this

environment, investors can customize a scan in the Profiler that searches out the stocks in Stage 1-3 (late Accumulation). The stocks in this stage are often the next ones to break out into an uptrend and follow the market higher. Although there is no sure way of knowing when or even if these candidates will move higher, investors can concentrate their analysis on the fundamentals that may lead to the uptrend. A company that may not yet be profitable but is reporting strong sales growth may be just around the corner from reporting earnings that could provide the catalyst for a sustained upward movement. And because it is unlikely that all the stocks in this stage will move higher, taking a quick look at fundamentals allows us to discard weak companies and focus only on the candidates with the greatest potential to move higher. You might be thinking that the Profiler may give you hundreds of Stage 1-3 stocks to choose from because if the market is just beginning an ascent, many stocks will be in that phase. The Profiler doesn't just scan for stages, however; it also allows users to customize their search by exchange, as well as by number of days in the stage, average daily volume minimums and maximums, and minimum and maximum prices. The more customized the user makes the scan, the fewer results there are to scrutinize (see Figure 1.11).

## **Stage 2: Markup**

Stage 2 is where most people want to be involved in a stock's cycle (see Figure 1.12). If you are bullish, it is where you make money. Markup begins where Accumulation ends. The charts have characteristics that make it easy to identify the transition from Accumulation to Markup. Presumably while the risks were higher because of uncertainty about the trend, participants who are bullish on the stock's future built large positions at low levels. Now they are ready to participate in the upside as the stock advances. The continuous buying in Stage 1 has taken half of the supply-and-demand equation out of the picture; supply has been reduced. Buyers depleted supply from the previous large owners while the stock was in the Accumulation phase, and anyone still long the stock will hold out for higher prices before selling. The perception of what the stock is worth is changing at this point, and in the markets, perception is reality. If you are an investor, the breakout into Stage 2-1 (strong Markup) is the perfect opportunity to buy your stock near the beginning of a strong move; then your work gets easy. In this phase of a stock's cycle, there are substantial gains, and your job is to monitor the strength of the stock using all the tools you are learning about to determine when to exit based on a discontinuation of the primary trend. If you are a trader, this stock will be one that you can trade over and over again to the upside as the stock continues to move higher throughout the strong (2-1), mid (2-2), and weakening (2-3) stages of the uptrend. For

MarketWise Profiler **ADVANCED SCREENER**

Submit      **PROFILER Home**      Trade Planner

Reset Defaults      WEEKLY ADVANCED SCREENER

STAGE: 1-3 (Late Accumulation) ▾

Days in Current Stage: 1 to 100

Price Range: .01 to 200

Average Daily Volume: 500000 to 100000000

Exchanges:  NASDAQ     NYSE/AMEX

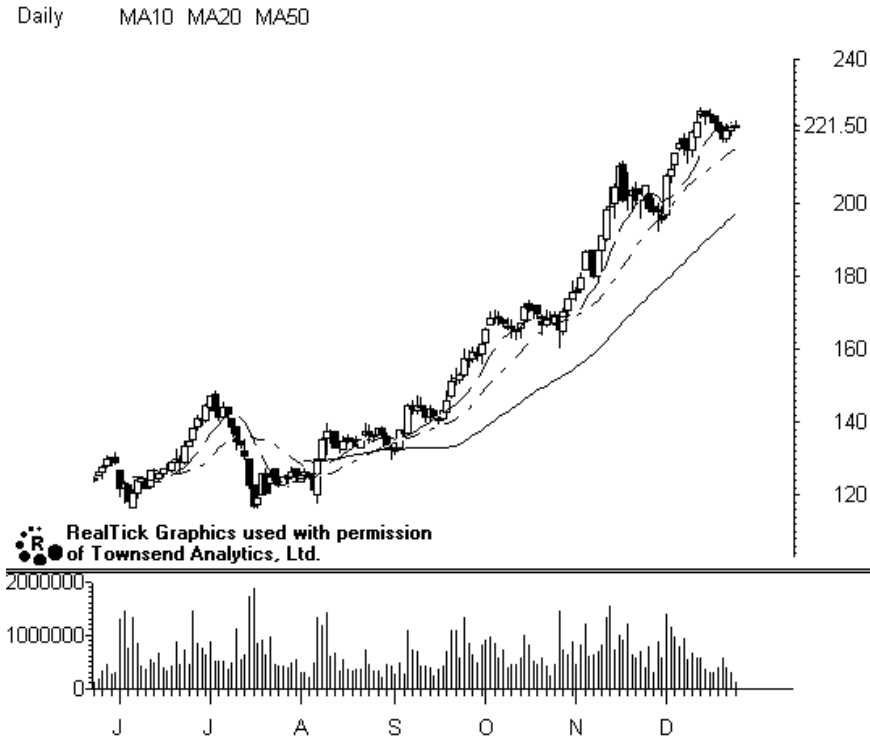
Include Only Symbols With MarketWise Ranking

102 Ticker Symbols Found with this Criteria

Symbols Only

1 2 3 4 5							
MW Rank	Ticker Symbol	Company Name	Latest Close	Stage	Days In Stage	Avg. Volume	Exchange
144	MERQ	Mercury Interactive Corp	45.41	1-3	7	2,479,985	NASDAQ
146	NILE	Blue Nile	28.95	1-3	7	550,515	NASDAQ
149	CHIR	Chiron Corp	33.58	1-3	5	1,744,205	NASDAQ
153	SRNA	Serena Software Inc	22.31	1-3	9	542,920	NASDAQ
158	ISIL	Intersil Holding Corp	16.39	1-3	4	1,940,400	NASDAQ
160	ASCL	Ascential Software Corp	15.09	1-3	4	912,815	NASDAQ
161	SLAB	Silicon Laboratories Inc	34.59	1-3	4	1,699,530	NASDAQ
162	NVLS	Novellus Systems Inc	28.58	1-3	3	4,158,430	NASDAQ
163	INTC	Intel Corp	23.76	1-3	3	73,307,955	NASDAQ
165	ENDP	Endo Pharmaceuticals Hld	21.32	1-3	4	687,780	NASDAQ
166	INFY	Infosys Technologies Ads	72.24	1-3	3	524,745	NASDAQ
167	LLTC	Linear Technology Corp	38.1	1-3	5	4,125,675	NASDAQ

**FIGURE 1.11** (Top) The Advanced Screener feature of the Profiler allows user-defined searches of over 6,800 individual stocks and exchange-traded funded to find the opportunities that make sense for your trading style. This screen allows the user to search out that stocks that are late in the Accumulation stage. Perhaps the results will show stocks that are ready to break out into the Stage 2 uptrend. (Bottom) This is how these results of the scan are displayed. The stocks that meet the specified criteria are ranked by MW Rank—the result of our internal MarketWise algorithms that sort for the best trading setups in each category. The display of screened stocks can be further sorted by clicking on any of the column headings such as company name alphabetically, by closing price or volume.



**FIGURE 1.12** Once this stock cleared 150, it experienced a large volume breakout above the rising 10-, 20-, and 50-day moving averages. In early September, the stock was considered to be in a strong uptrend (Stage 2-1). This stage represents the highest probability for further upside to come. Note that the solid line represents the 50-day MA, the short dashed line—the 20-day MA, and the long dashed line—the 10-day MA.

investors who may have missed the original opportunity to get in at the beginning of the trend, the continuation patterns through the substages of the Markup offer a low-risk point to get in and participate in significant gains with risk minimization techniques that are found on shorter time frames. Although we will not explore each of the continuation patterns in uptrends, we will study the reason (which is more important) for continuation and how to determine when the stock has a low-risk/high-profit potential to continue the advance.

For bullish traders interested in finding stocks that are moving now, the Profiler allows customized screening of 6,800 different stocks to search out the stocks in each of the three substages of Markup: strong (2-1), mid (2-2), and weakening (2-3). Each of these substages can be further screened by days in the stage, price and volume ranges, and exchange preference (see Figure 1.13).

**MarketWise Profiler ADVANCED SCREENER**

STAGE

Days in Current Stage  to

Price Range  to

Average Daily Volume  to

Exchanges  NASDAQ  NYSE/AMEX  
 Include Only Symbols With MarketWise Ranking

**161 Ticker Symbols Found with this Criteria**

Symbols Only

1 2 3 4 5 6 7							
MW Rank	Ticker Symbol	Company Name	Latest Close	Stage	Days In Stage	Avg. Volume	Exchange
3	SNDK	Sandisk Corp	25.54	2-1	6	6,979,345	NASDAQ
4	GRU	Gurunet Corporation	22.32	2-1	2	1,664,540	AMEX
5	XXIA	Ixia	17.86	2-1	2	1,130,495	NASDAQ
6	QLGC	Qlogic Corp	42	2-1	19	3,120,315	NASDAQ
7	AAPL	Apple Computer Inc	85.29	2-1	28	19,255,080	NASDAQ
9	PGH	Pengrowth Energy Tr	22.58	2-1	1	634,845	NYSE
11	LZ	Lubrizol Corp	41.71	2-1	12	586,190	NYSE
12	ACL	Alcon Inc	85.05	2-1	8	528,295	NYSE
14	NIHD	Nii Holdings Inc	56.19	2-1	4	530,695	NASDAQ
15	SEPR	Sepracor Inc	63	2-1	3	2,225,375	NASDAQ
16	GRP	Grant Prideco Inc	23.01	2-1	9	1,440,425	NYSE
17	SLB	Schlumberger Ltd	72.69	2-1	14	4,594,225	NYSE
18	SCHN	Schnitzer Steel Indust	36.72	2-1	7	775,460	NASDAQ

**FIGURE 1.13** (Top) This Profiler screen is used to search out the strongest uptrending stocks; that is, the stocks with the greatest likelihood of further gains to come. (Bottom) The bottom screen shows 161 candidates of stocks in strong uptrends. By further refining the search criteria, the list of candidates can be narrowed, freeing your time to follow only the stocks that meet your criteria.

### Stage 3: Distribution

Distribution is the slow process of sellers gaining control of a stock as buyers become less aggressive in their purchases. This is the third stage of a stock's cyclical movement and it represents the gradual transition to a Stage 4: Decline. During the distribution process, large holders of the stock from lower prices start to slowly move out of their positions to lock in profits. The sellers usually do not encounter much difficulty unloading their stock to the market because it is in this stage that good news is commonly associated with the stock. Unfortunately for many amateur investors, it is the "good news" that gets their attention and becomes a catalyst for them to buy. As we know, professionals anticipate good news and when it finally comes out, the professionals are only too happy to sell their stock to the eager public buyers. The public's buying can be quite strong after these news events and it allows the professionals to sell large quantities of stock that results in a stock that often gets stuck in a trading range. This process of professionals selling to amateurs is known as the stock "moving from strong hands to weak hands." As mentioned, the market is forward looking, and a basic understanding of business cycles tells you that things don't stay strong forever.

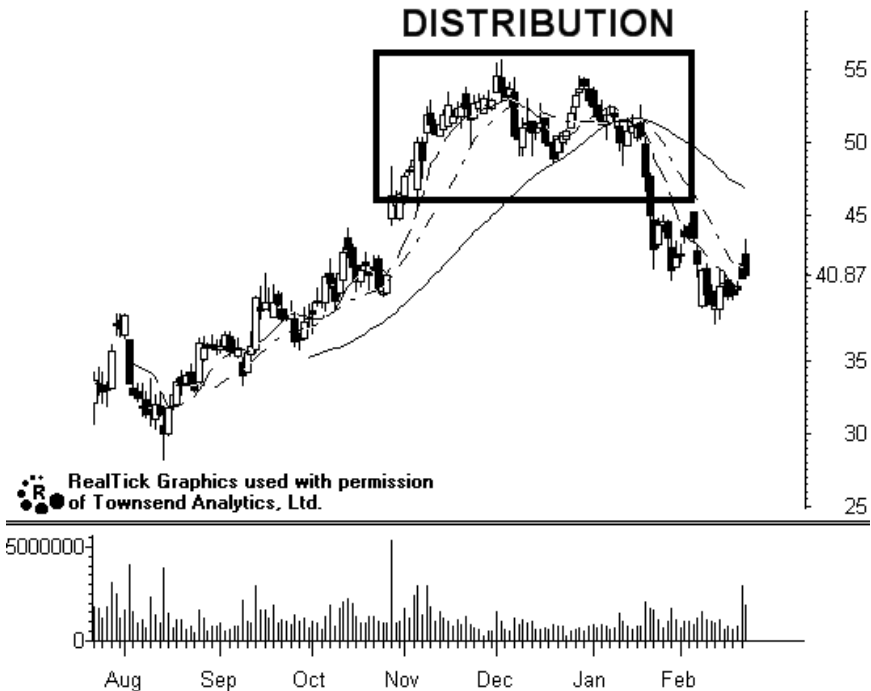
One of the easiest ways to recognize a stock is undergoing distribution comes from the moving averages. During the sideways action, the moving averages will start to flatten out as range constricts and these moving averages will also start to oscillate above and below each other (see Figure 1.14). The moving average crossovers represent indecision and that is the trend trader's clue to avoid being involved with the stock.

Once again, the Profiler simplifies finding the stocks that are undergoing distribution and may be ready for a decline. For the short seller who is searching out candidates for decline, the best results will typically be found with stocks that are in the late stages of distribution (Stage 3-3). These stocks are the most vulnerable to the pressure that allows the sellers to regain control of the trend. Stocks that are being considered for a short sale should have higher volume than you might see in an up trending stock because it can be difficult to cover your position during short-term "short squeeze" rallies. It is also dangerous to sell short the stock in Stage 3 until there is evidence of an actual downtrend confirmed by a lower low in price. Selling short early will put you at an immediate disadvantage; you will be in a position of weakness instead of entering in a strong position as the stock heads lower (see Figure 1.15).

### Stage 4: Decline

Simply put, Stage 4 of a stock's lifecycle represents a bear market. Stocks that are in down trends should not be purchased for any reason, regardless

Daily MA10 MA20 MA50



**FIGURE 1.14** Moving average crossovers represent indecision and are most commonly found in Stages 1 and 3.

of how good the news may appear. If you are not comfortable selling short (see Chapter 4 for more on selling short), the best position you can have is cash as a stock makes its inevitable decline. Stage 4 is the stage that does the most damage to traders' and investors' accounts and learning to recognize these stocks and avoid their vicious declines can save the equity you have worked so hard to build in your accounts. Longer-term investors who consider buy and hold as the best strategy should pay particular attention to signs of weakness, as the bear market of 2000 to 2003 taught many participants that stocks do not "always come back."

A stock first enters Stage 4 as the lows of Stage 3 are broken. In order to assure the trend is truly lower we want to see the stock below the declining moving averages (see Figure 1.16). Further, the short-term MA should be below the intermediate term MA, which should be below the longer-term MA. Having the three moving averages confirming the direction of the stock gives us added confidence that the weakness will persist and it is not just a short-term pullback.

MarketWise Profiler ADVANCED SCREENER

STAGE

Days in Current Stage  to

Price Range  to

Average Daily Volume  to

Exchanges  NASDAQ  NYSE/AMEX

Include Only Symbols With MarketWise Ranking

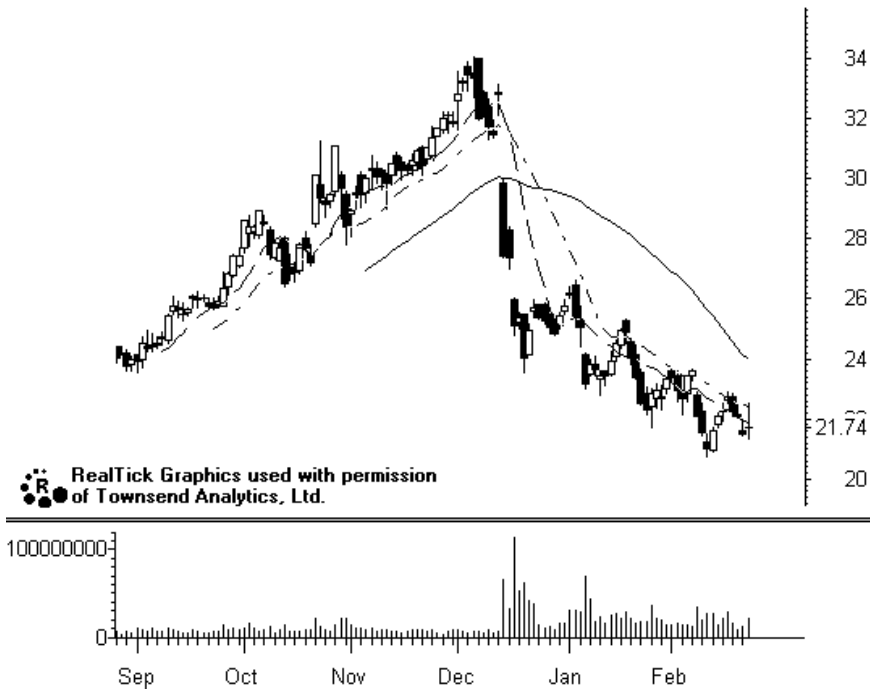
56 Ticker Symbols Found with this Criteria

1 2 3

MW Rank	Ticker Symbol	Company Name	Latest Close	Stage	Days In Stage	Avg. Volume	Exchange
	ACDO	Accredo Health Inc	30.24	3-1	2	674,540	NASDAQ
	ACF	Americredit Corp	23.36	3-1	1	1,045,035	NYSE
	APCS	Alamosa Holdings Inc	12.56	3-1	9	1,145,095	NASDAQ
	APPX	Amer Pharmaceutical Ptnrs	50.8	3-1	12	690,660	NASDAQ
	ATVI	Activision Inc	21.44	3-1	2	4,112,220	NASDAQ
	BEC	Beckman Coulter Inc	68.11	3-1	2	812,115	NYSE
	BRL	Barr Laboratories Inc	46.31	3-1	12	631,040	NYSE
	C	Citigroup	47.95	3-1	1	13,213,225	NYSE
	CAM	Cooper Cameron Corp	55.12	3-1	1	1,360,390	NYSE
	CELG	Celgene Corp	27.45	3-1	1	1,273,280	NASDAQ

**FIGURE 1.15** (Top) The Profiler allows the user to search stocks that are in each of the three substages of the overall primary stage, which in this case is a Stage 3 Distribution. (Bottom) The bottom scan for Stage 3-1 stocks shows results for 56 different securities. This group of stocks may be one that longer-term holders with unrecognized profits might want to sell covered calls on.

Daily MA10 MA20 MA50



**FIGURE 1.16** The typical pattern of lower highs and lower lows that define a downtrend. A downtrending stock should be considered “guilty until proven innocent.” Note, the faster 10 period MA (long dashed line), leads the 20 MA (short dashed line) and the 50 MA (solid line).

There are many opportunities for aggressive traders to profit from a stock that is declining in value by participating on the short side. Short sales are a bit tricky for a couple of reasons. First you need to be sure that your clearing firm has shares to borrow. Another obstacle with short sales is that it must be done on an uptick and finding an uptick in a stock that is heading lower can be difficult. If selling short, you should anticipate that the stock may move against you for a little because you have to sell into strength as a result of the short sale rules.

The Profiler allows bearish traders to scan 6,800 securities in seconds to find those in Stage 4. Looking at the Profiler to find the best short sale candidates is easy. First we use the drop-down menu to search out stock in the strong stage of a decline (4-1) as these stocks should have the most opportunity for further decline. How long the stock has been in a Stage 4-1 is not a major factor, so we can leave the default of 1 to 100 days in place. Price range needs consideration because exchange guidelines make it difficult to

MarketWise Profiler ADVANCED SCREENER

STAGE

Days in Current Stage  to

Price Range  to

Average Daily Volume  to

Exchanges  NASDAQ  NYSE/AMEX

Include Only Symbols With MarketWise Ranking

31 Ticker Symbols Found with this Criteria

1 2

MW Rank	Ticker Symbol	Company Name	Latest Close	Date	Stage	Days In Stage	Avg. Volume	Exchange
5	VRSN	Verisign Inc	25.37	08/04/05	4-1	2	6,491,080	NASDAQ
12	ROST	Ross Stores Inc	26.54	08/04/05	4-1	2	1,453,825	NASDAQ
13	AVID	Avid Technology Inc	40.28	08/04/05	4-1	16	1,817,595	NASDAQ
16	INSP	Infospace Incorporated	24.74	08/04/05	4-1	6	2,319,735	NASDAQ
25	PETC	Petco Animal Supplies	27.71	08/04/05	4-1	2	935,520	NASDAQ
27	ANDW	Andrew Corp	11.17	08/04/05	4-1	5	2,455,480	NASDAQ
29	NTAP	Network Appliance Inc	25.5	08/04/05	4-1	11	6,004,615	NASDAQ
38	SWFT	Swift Transportation Co	21.43	08/04/05	4-1	9	935,720	NASDAQ
41	HOTT	Hot Topic Inc	16.52	08/04/05	4-1	5	1,644,660	NASDAQ
42	MVSN	Macrovision Corp	18.17	08/04/05	4-1	3	1,096,960	NASDAQ
46	WOLF	Great Wolf Resorts	12.46	08/04/05	4-1	5	872,345	NASDAQ
58	ZBRA	Zebra Technologies Cp A	38.23	08/04/05	4-1	1	1,142,015	NASDAQ

**FIGURE 1.17** (Top) Searching the strongest down trending stocks (Stage 4-1) is where you would begin looking for stocks to sell short. (Bottom) At the time the scan was run, the Profiler identified 31 candidates for potential short sales.

sell short stock under \$5.00. Therefore, we type in a price range of \$5 to \$50. As mentioned, volume is an important factor. Because we need to be sure there is plenty of liquidity, we use a minimum volume criteria of 800,000 shares. To further hone our list, this example also shows just the stocks that are trading on the Nasdaq (see Figure 1.17).

Recognizing which stage a stock is in at any particular point in its life cycle is an invaluable tool for traders and investors alike. Because Stage 1 and Stage 3 are typically represented by lower volume and volatility they do not make for good trading candidates. The easiest way to identify if a stock is in Stage 1 or 3 is to observe the moving averages. During periods of indecision (Stage 1 and 3), the moving averages oscillate above and below price as well as cross above and below each other.

Trend following is where big money can be made when trading and investing and that is why your focus should be on stocks that are in either Stage 2 or 4. For bullish traders, the only choice should be to look for stocks that are in a solid Stage 2 uptrend. As we will learn later in this chapter, “a trend, once established, is more likely to continue than it is to reverse.” Of course you do not want to blindly buy any stock that is moving higher, we discover later in this chapter how to time our entries using shorter-term time frames. Just as you can make solid returns going long Stage 2 stocks, bearish traders focus on stocks that are in established Stage 4 down trends. When a stock is heading lower, it is much more likely to continue lower than it is to turn around and head higher again.

## **SUPPORT AND RESISTANCE**

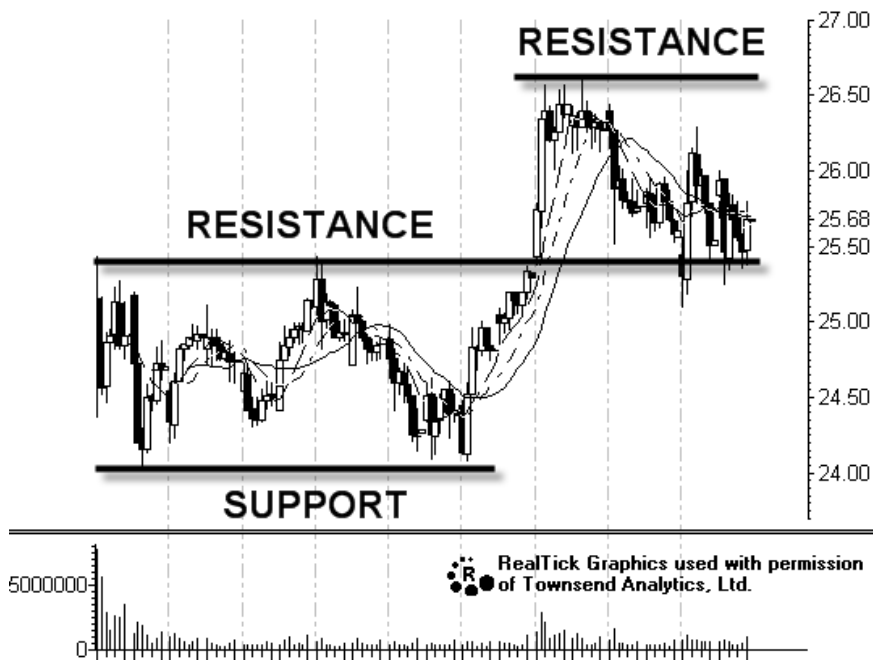
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Support and resistance levels are where you really get to see the ongoing battle between the buyers and sellers at various price levels and lets us see more clearly how prices actually move from one level to another (see Figure 1.18). The continual battle between the bulls and bears is what makes the stock market such a fascinating study of the basic laws of supply and demand. Technicians study how stocks act at levels of support and resistance so that when a trend finds renewed strength, they are sure to be on the right side from the beginning, which allows them to capture a larger portion of a move. Support and resistance levels offer the structure upon which trends are built and because of that, a solid understanding of them is imperative.

### **Definitions of Support and Resistance**

*Support levels* are price levels where there is likely to be enough buying pressure (demand) to offset selling pressure (supply) and provide a tempo-

Intraday (60-Min) MA8 MA13 MA21



**FIGURE 1.18** While consolidating in a Stage 1: Accumulation or Stage 3: Distribution, stocks trade between levels of support and resistance until the buyers or sellers gain control of the momentum and push the stock higher or lower. The moves between levels of support and resistance represent tradable opportunities.

rary halt to declines. When prices fall to a new low and then rally, it is common for buyers who missed out on the first move to place bids near the prior low in hopes of participating in the next bounce, this demand helps create support. Another factor that helps create support at the prior low is a lack of supply. Sellers realize that the last time prices reached this low level the buyers took control of the stock, so they will often defer decisions to sell, this removes supply from the equation. Support on a daily chart is usually an area (e.g., 34 to 34.50), not a specific number (e.g., 34.20). However, on short-term time frames, support is often a specific price. This is one of the biggest advantages to timing trades on the shorter time frames. Increasing entry accuracy improves the profit potential, but more importantly, it minimizes any loss if the market does not agree with your analysis.

*Resistance levels* are price levels where selling pressure (supply) is likely to offset buying pressure (demand) and halt advances in the price of stocks. Resistance levels are formed because there is a large enough

source of supply that the buyers cannot immediately overcome. When a stock reaches a new high and then retreats from that level it leaves many participants wishing they had sold at that high level. The next time the stock is able to rally back to the high, sellers offer stock to the point of overcoming demand, and this is the creation of resistance. Another factor that helps to establish the prior high level as a resistance area is an unwillingness by new buyers to pay up for the stock in an area where there were prior sellers. This lack of demand is also instrumental in the development of resistance. Resistance on a longer-term time frame such as a daily or weekly charts, is also defined as an area, such as 40.00 to 40.40, not a specific number; the same is true for resistance on shorter-term time frames. It is worth repeating that the benefit to traders who take the time to study shorter time frames is found in being more precise.

Think of both support and resistance as an area where buyers and sellers fought a battle. This battle often leaves a memory for both bulls (buyers) and bears (sellers). Because price levels represent where these battles were fought, participants will often return to these price levels until an ultimate victor is declared. Therefore, when looking at longer term time frames, we can expect both support and resistance to be represented by a broader area, fought out on a larger battlefield. Whereas, on short time frames, we can expect to isolate these price levels to more specific numbers. Both are valuable to know.

Now let's discuss some general rules of support and resistance that will help in not only entering trades, but in managing trades as well.

### **Once Broken, Support Tends to Act as Resistance**

Have you ever bought a stock near a level you viewed as support, only to watch it decline in price and wish you could just get out at breakeven? This type of buyers' remorse shows up on a chart as resistance once the stock rallies back up to the prior support level, while you and others offer stock back in the attempt to break even on the trade. Obviously, one person's stock won't offer much resistance, but when the support level is an important level for the stock; many more people are involved and it becomes much harder for the stock to work through the supply being offered before it can move higher. What makes it an important level has a lot to do with how much time the stock spent at a certain price area and how much volume traded within that area. It is said that price has memory; well, that is just a function of human nature; the more participants at a prior level, the greater the memory (think resistance) will become.

Besides the people who wish to liquidate their long positions at a prior level of support, there are also short sellers waiting in the wings for the

stock to rally back to that prior level. Let's use an example of a stock that had found support near \$55 for a period of four months and then it suddenly breaks lower down to \$48. Obviously the people who purchased at \$55 are not going to be very happy and on any subsequent rally back up towards \$55 would entice a good deal of those folks who bought near \$55 to offer their stock out (weak holders). Specialists and market makers are not dumb, when they see all the stock being offered they are not very likely to be aggressive bidders for the stock. The lack of demand creates a fragile environment for the stock as the bids do not support much supply, making it vulnerable to a decline. Now we need to consider the short sellers. Sharks that smell blood in the water and sense an easy opportunity to take advantage of weak holders of stock. The short sellers will be aggressive in offering out stock that they do not own, in hopes that someone will purchase it from them and they can buy it back cheaper at a later point. This added source of supply creates an even more precarious situation for the long holders; this is why stocks often fail miserably after they test support multiple times. When you see a stock that breaks down through support, get out immediately if you are long, do not wait for a bounce back up, the market is not always so accommodative! Remember that when support is broken it will not always become resistance, but it is the greatest odds that it will. With no certainties in the market we have to go with the strongest odds. (See Figure 1.19.)

### **Once Broken, Resistance Tends to Act as Support**

For this example, let's consider a stock that has been trading in a Stage 1: Accumulation for a period of seven months. During the course of the narrow, range-bound trading in which the accumulation took place, the stock may have traded in a range of \$20 to \$23. Certainly there are some institutions that may have accumulated very large (millions of shares) long positions. At the same time, there are always the skeptics about a company who may have created a short position in the range. One day, the company announces earnings that are much better than what the analysts had expected and the stock immediately surges up to the \$27 level on heavy volume. The institutions with the large positions are very pleased and they may even start to sell a few shares to lock in some profits. Over the course of the next week or so, the stock grudgingly drifts back down toward the \$23 to \$23.50 level and that is when the dynamic of prior resistance becoming support begins to unfold. The institutions realize that the stock is near prior resistance so they stop taking profits; this reduces the supply available for the stock. At the same time, the short sellers realize that this is their chance to minimize their losses and they decide to cover their positions near the level they sold short, this creates demand. Now consider the

Daily MA10 MA20 MA50



**FIGURE 1.19** Support at the 38 level was broken and the subsequent rally could not find enough strength to push back up through that level, a classic example of support becoming resistance.

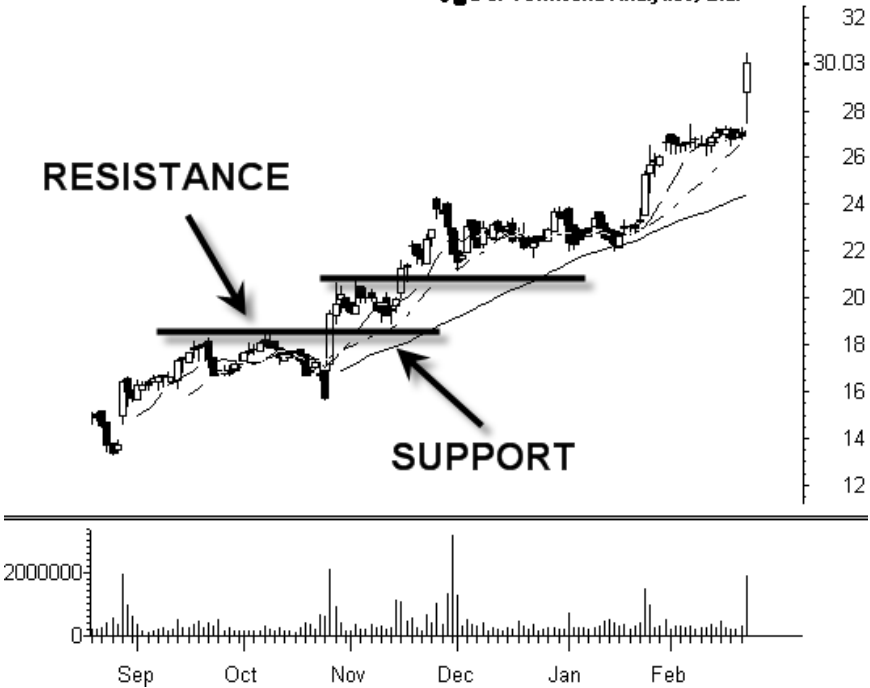
participants in cash, seeing the lack of sellers and the renewed aggressive bidders, they decide to buy stock, and this creates more demand. Without a willing source of supply combined with aggressive buyers, it is not hard to understand why the tendency for prior resistance to become support is so strong. (See Figure 1.20.)

### **The More Often Support or Resistance Is Tested, the More Likely That Level Is to Fail to Hold Back Price Movement**

To understand this occurrence, it is once again important to consider the impact of the largest participants in the market. Suppose an institution had 1,800,000 shares of a stock that they wanted to get out of. Obviously they would not be able to sell such a large block of stock all at once; instead it may take them as long as a month to six weeks to dispose of such a large

Daily MA10 MA20 MA50

RealTick Graphics used with permission of Townsend Analytics, Ltd.



**FIGURE 1.20** Notice how this stock found support at prior levels of resistance as it corrected the violent moves higher.

position. You have to consider how they would sell the stock. If they were to sell it aggressively on the bids their selling would create weakness that would result in a lower average price for their sales. The market impact cost of selling aggressively is why an institution would give his broker orders to “sell it between \$39 and \$40 and give me reports as you get fills.” What he is saying is that the broker can exercise his discretion to sell between prices of 39 and 40 for as long as it takes to complete the order. The broker who receives this order sees that the stock has just rallied from \$35 to \$39 so he decides to start selling into the upward momentum. Over the next day or two, that broker may sell as many as 500,000 shares before the stock dips back below \$39 and he stops selling. During the next three weeks, the stock trades as low as \$37 and then recovers back into the \$39 to \$40 range where the broker once again resumes selling the 1.3 million share balance. This time, the broker is able to unload 700,000 shares between 39 and 40 before the buyers recognize there is a source of supply too big for them to overcome. This sets the stock back into a short-term

correction that sees the stock trade down toward \$38 before the buyers gain control and push the stock back up into the brokers sell range again. Now the broker has just 600,000 shares to sell and he is able to sell 450,000 of them before the buyers once again lose momentum and the stock corrects down toward \$38.50. Days later, the stock pops back above 39 and the broker is able to sell the remaining 150,000 shares of the original 1.8 million share order.

What has happened in this institutional selling situation is that each time the stock traded into the range of 39 to 40 the primary source of supply that was holding the stock back was being depleted. Supply was being absorbed into the market until the order was finally completed. It is very common for a stock that undergoes this type of distribution to surge past the \$40 level once the primary supply was bought. This type of situation is where traders should be alert for clues to go long. (See Figure 1.21.)

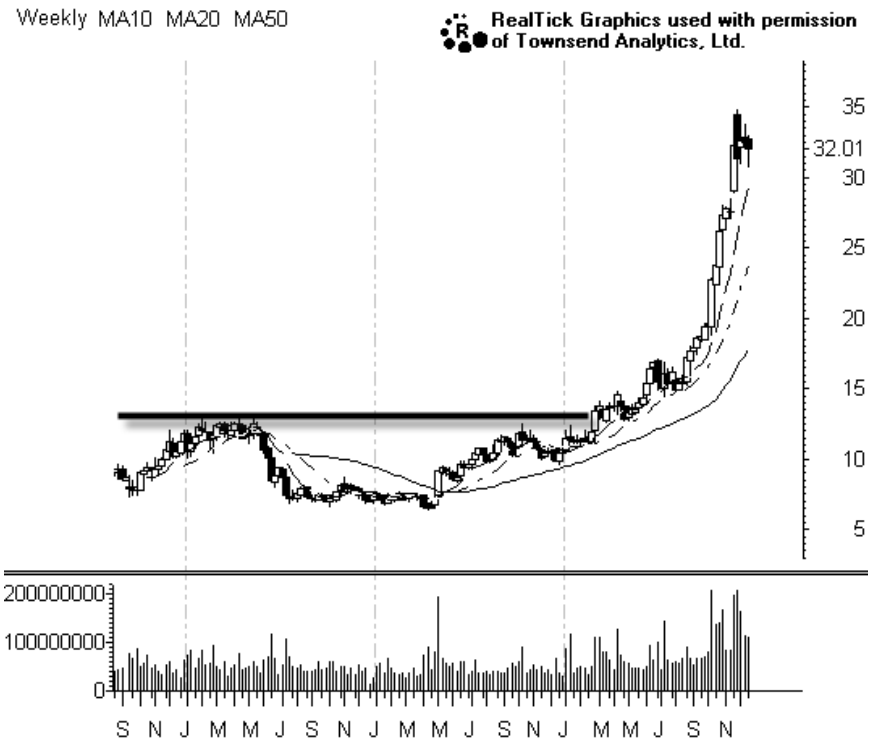


**FIGURE 1.21** Resistance at the 17.00 price level was tested numerous times before the demand gradually overwhelmed the supply being offered at that level and the stock then broke out and trended higher.

### The Longer the Trend Has Been Neutral (Consolidating), the More Significant the Eventual Breakout Becomes

Whether a stock is in a Stage 1: Accumulation or a Stage 3: Distribution, the longer the stock has been trading in a narrow range, the bigger a move will be once the stock begins trending. One of my favorite types of stocks to trade are the ones that have been in a longer-term accumulation and they suddenly break out past resistance on a big surge in volume (Figure 1.22). These stocks are usually not household names, at least not as they begin their moves. For long candidates, I like to use the Profiler to help me find stocks that are in a Stage 2-1 (strong markup) on a weekly time frame.

Approximately once a week, I will scan through the stocks that meet the 2-1 weekly criteria for candidates that have “woken up out of a long coma.” What I watch for is at least two times the average daily volume on



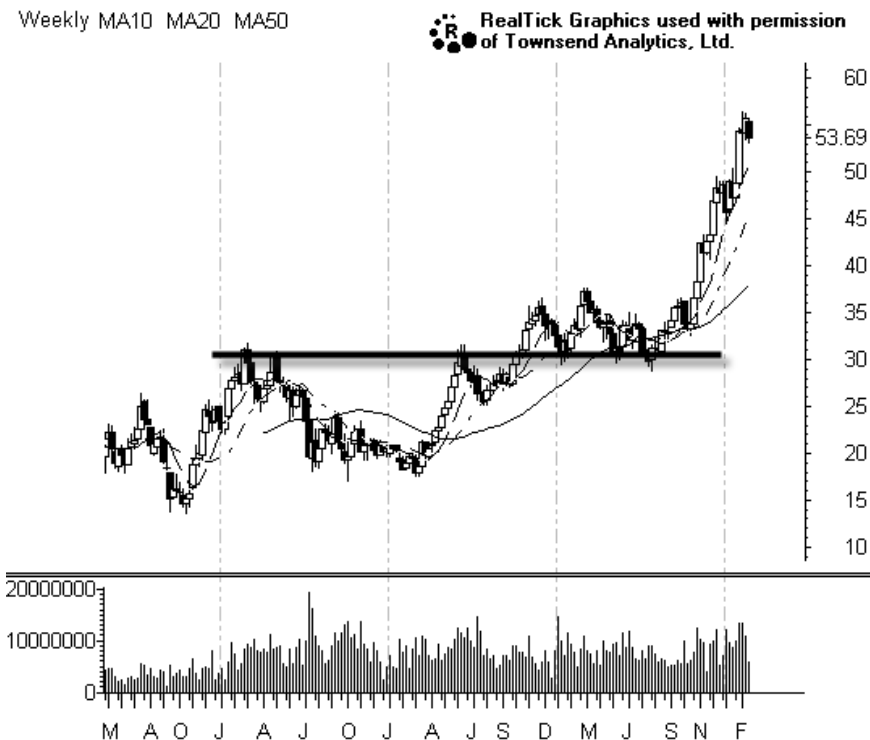
**FIGURE 1.22** Example of a significant breakout after the prolonged accumulation period. When shares of this stock broke out past multiyear resistance near \$14.00, the stock began an uptrend that saw gains of over 100 percent in less than six months.

Weekly MA10 MA20 MA50



**FIGURE 1.23** While it is not certain that the prior support near 40 (broken) would lead to resistance that could not be overcome, buying near this level would not be as high a risk if this potential resistance level were not present.

the breakout followed by a low volume consolidation. I have found that these stocks are exceptional candidates for continued moves higher. In the case of short sales, tops usually take less time to develop than bottoms so I look for stocks that have been trading in a tight (2-3 point) range for at least 4 to 5 months, these stocks can be found by doing a search of the Stage 3-3 stocks. Once these stocks break down to new lows, they become ideal shorting candidates. One phrase you may want to remember is “the bigger the top, the bigger the drop.” This simply means that the longer the stock has been consolidating in a Stage 3 pattern, the more participants will be trapped long when the stock breaks down and that can create some fearful selling over the next few months, which makes these stocks ideal for short selling opportunities. See Figures 1.23 and 1.24 for examples of resistance becoming support and support becoming resistance.



**FIGURE 1.24** The multiyear resistance near 30 acted as a strong floor of support for nearly a year before this stock resumed a strong uptrend.

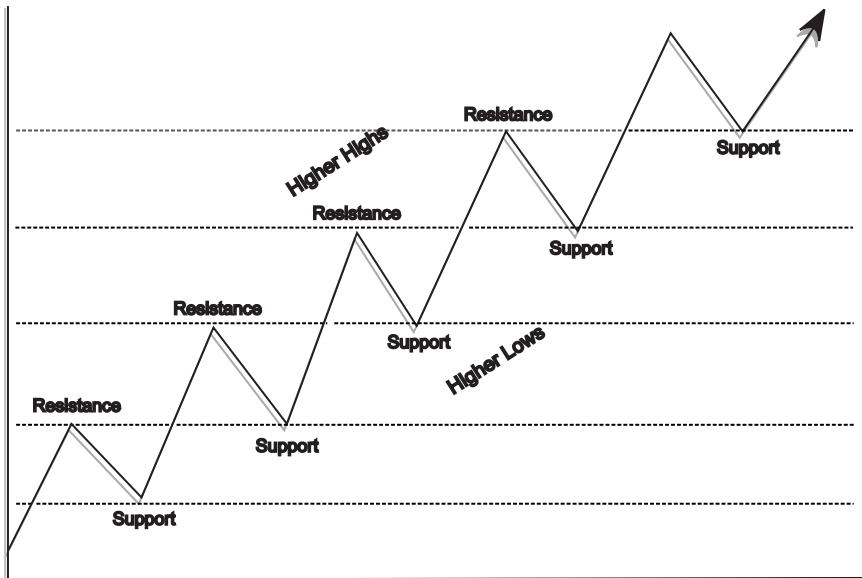
## TRENDS

There are three things that a stock can be doing at any given time, it can go up, go down, or trade sideways. Our goal as traders is to find the high potential/low risk trades in a trending stock in an attempt to participate in the trend for as long as the market tells us to. To a lot of people that last point I made about “as long as the market tells us to” may sound confusing, so before delving into trends we cover this important topic. Technical analysis is largely about objective observation about the action of stocks, futures, or whatever you choose to trade. If you consider what we really know versus what we are told about market related events, you begin to realize that the only truth comes from price. The market is made up of millions of different participants, all with the same goal, to make money. To succeed in the market, you must view those other participants as your opponents, someone wins and someone loses. The ones who are consistent

winner in the market are those who can separate the noise (analyst reports, television and radio banter, earnings reports, etc.) from the truth. The truth is represented through price. Price is the only thing that pays us in the market, which makes it the most important factor to consider in our analysis. When we “listen to the market” we are merely observing the cumulative effect of the millions of participants in order to anticipate how their future behavior will affect price movement. Once we understand human nature, we can understand market movements and be in a better position to capitalize using forward thinking analysis, rather than relying solely on what has already happened.

To succeed as traders and investors, we need to have faith in technical analysis, not blind faith, but faith in the cyclical nature of the market. This is to be backed up with disciplined implementation of a strong money management plan. If you observe market action carefully, you will begin to understand that, most of the time, the market is consolidating, either digesting gains or stabilizing after a decline. The second most likely type of market action is a continuation of the most recent trend; this is where we become interested. Finally, the least likely event is for perfect timing when the market reverses course. Since we cannot make very good money trading consolidations and because reversals are harder to time, it makes sense that trend trading is where we should focus our attentions for money-making opportunities. One of the foundations of technical analysis is that “prices move in trends” and once those trends have been established, they are more likely to continue than reverse. More likely does not mean they will always continue, but it does mean that is where our best odds for profit come from and with stops to protect us when the market does reverse, we should never get hurt too badly.

Uptrends are represented in the Stage 2: Markup cycle of a stock's life and they are defined by *a series of higher highs and higher lows* (see Figure 1.25). For swing traders, a general rule for trend determination on a daily time frame is to look at the direction of the 50-day moving average. If the 50-DMA is advancing the stock should be considered “innocent until proven guilty.” Uptrending stocks will not go straight up, instead they tend to surge and then pause. It is our objective to be involved in the stock while it makes the swings higher and be out when the trend dissipates or starts to show signs of reversing. After each surge higher, the stock will experience a corrective move that allows the gains to be digested. These short-term corrections can occur one of two different ways. They will either correct by experiencing a pullback in price or they will correct by consolidating those gains through time (see Figure 1.26). When a stock experiences a quick rally, let's say from 22 to 26, there will typically be some profit taking in the stock. The profit taking will usually last anywhere from 2 to 10 days, any longer than that will lower the odds

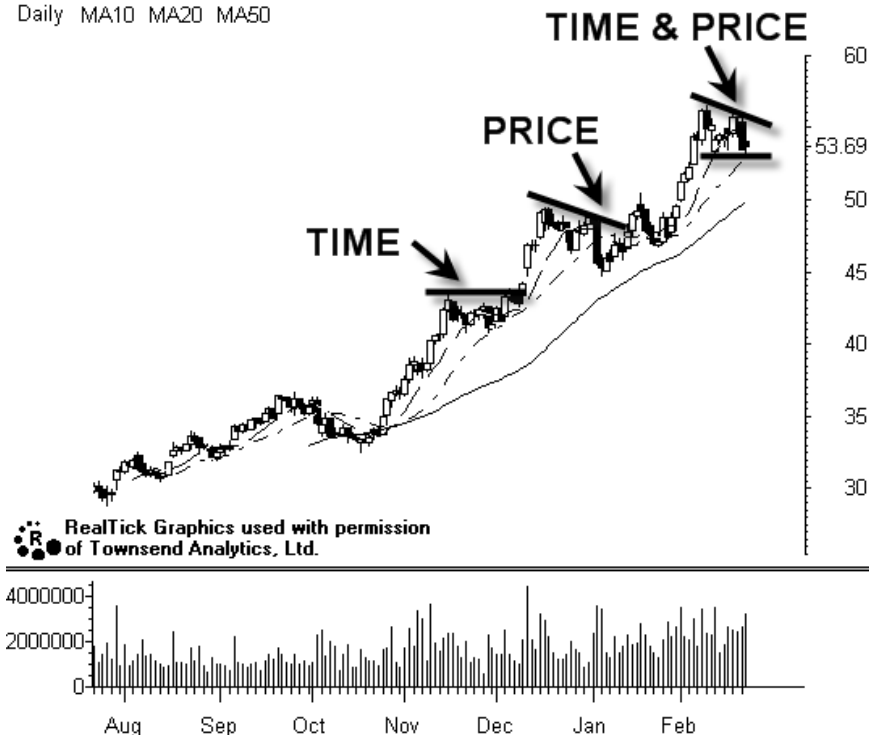


**FIGURE 1.25** The diagram shows how a stock is supposed to look in an uptrend. The uptrending stock is formed as the stock makes higher highs and higher lows; it is the pullbacks that allow traders a low-risk opportunity to get long a stock whose path of least resistance is higher.

of a continued move higher. After this short-term correction, the stock may find support near \$24 before continuing its ascent. The pullback in price in this case was necessary to bring the price back down to a level where supply and demand reached an equilibrium (which was found at support at \$24) before buyers once again re-exerted their conviction. When a stock corrects its gains by trading in a narrow sideways range, it is said to be correcting through time. A correction through time occurs when the same stock, which rallied from 22 to 26, does not experience a price correction, instead it holds onto its gains and might find support through strong bids near 25.50. A correction through time is actually considered to be more bullish than one by price because it shows a lack of motivated sellers and more importantly, it shows there are buyers who are attempting to quietly purchase shares on the bid. While the buyers aren't aggressively purchasing from the offer, they are signaling underlying strength with their methodical purchases at the bid price. The stocks that correct through time are typically strong candidates for trend continuation once the high of the consolidation has been traded through.

A common mistake among traders is to limit their study of price action and trends to just one time frame. It is important to recognize that there are trends within trends and the longer-term trend is nothing more

Daily MA10 MA20 MA50

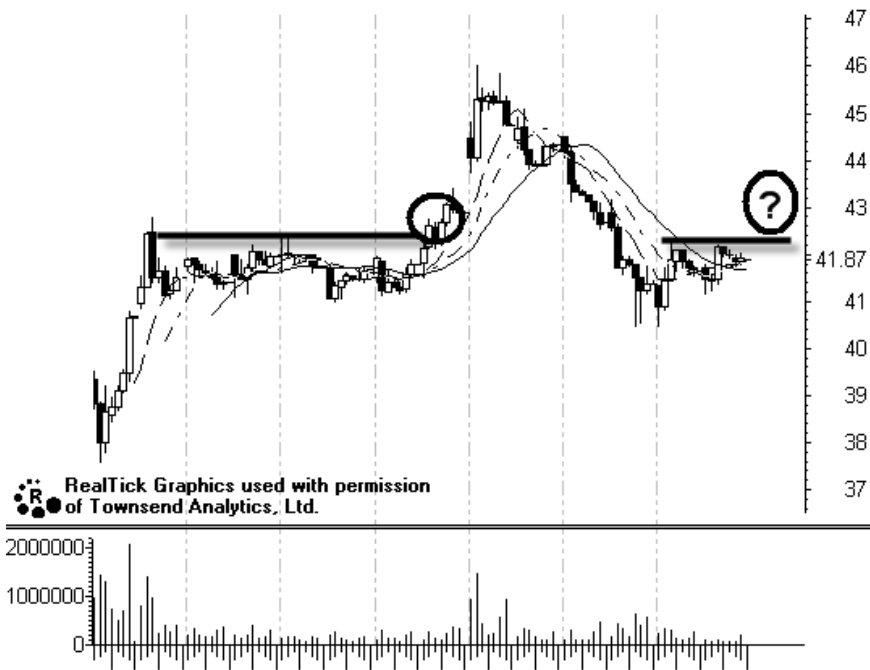


**FIGURE 1.26** The corrections in a Stage 2 uptrend will occur either by correcting through time as the stock trades sideways or by pulling back price wise.

than the sum of a number of shorter-term trends. For our purposes, we will be looking at stocks that are trending on a longer-term basis and then timing our entry into those longer-term trends by recognizing opportunities on a shorter-term time frame, such as the hourly time frame in Figure 1.27. What we want to do is make sure that the short-term and longer-term trends are in alignment; this allows us to gain a statistical advantage in our trading decisions. For entering long positions, the primary trend (found on a daily time frame) should be in Stage 2 while the short-term trend (found on the 60 minute time frame) should be transitioning from a Stage 1 to Stage 2. By purchasing the stock as the short-term trend confirms the longer-term trend, we are buying the stock as momentum returns and we also have a logical place to set stops. Stops should be placed just below the low of the short-term Stage 1 that was identified on the hourly time frame.

Before we move on, it is important to point out that while it is possible to make money selling short stocks as the stock pulls back in a primary uptrend, the odds for success in this type of trade aren't very good compared

Intraday MAB MA13 MA21

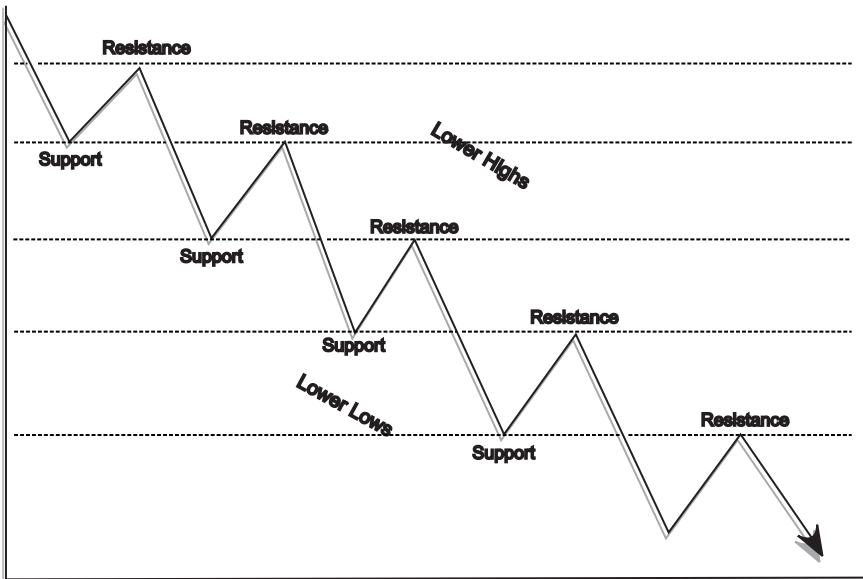


**FIGURE 1.27** A shorter-term time frame like the one here with 60-minute candles over 20 days allows us to gain further clarity about a stock in a primary uptrend. This closer look at the stock allows us to time our entry into a stock just as the buyers regain control of the trend. The circled area with the question mark represents a potential buy opportunity, but only if buyers can regain control and push the stock past short-term resistance, and make a higher high.

to buying a strong stock on pullbacks. The very definition of an uptrend assures there will be greater opportunity to make money by trading in the direction of the primary trend. A series of higher highs and higher lows implies that the sum of the rallies will always be greater than the sum of the declines. It should also be noted here that news and surprises tend to follow the direction of the trend. Meaning that in an uptrend, it is more probable that news releases are likely to be positive for the stock. In trading, we want to do whatever we can to increase the likelihood of a favorable outcome and trading with the trend is the easiest first step in creating a consistent edge. The Profiler makes it easy to consistently find the stocks that are in the uptrending stage not just on the daily time frame, but also on the longer-term weekly time frame.

Downtrends are represented in the Stage 4: Decline cycle of a stocks life and they are defined by a series of *lower highs and lower lows* (see

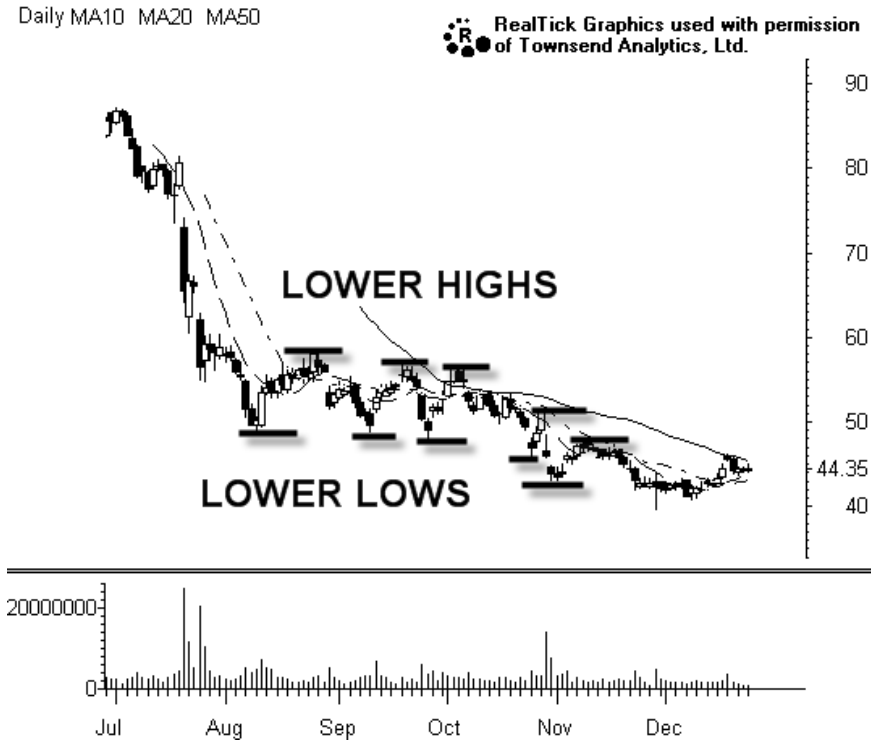
Figure 1.28). Again, the direction of the 50-day MA is a quick reference tool to determine the overall trend of the stock and in a downtrend, as long as the 50-DMA is declining, the stock should be considered guilty until proven innocent. Just as an uptrending stock does not go straight up, a downtrending stock will not typically drop all at once (but it is a great feeling when they do and you have a short position). Stocks in downtrends will typically experience quick and sharp sell offs followed by short-term corrections of the weakness. Just as we saw with uptrending stocks, these corrections will occur either by price or through time. Let's consider a stock that drops from \$45 to \$40; once the sellers have been exhausted and buyers start to slowly gain control of the short-term trend, the stock will typically experience a rally that may last anywhere from 2 to 10 days. As long as the high during the corrective rally does not exceed the prior high, near 45, the stock should be monitored for opportunities to be sold short. If instead of experiencing a corrective rally, the stock begins to trade sideways in a narrow range near the lows, the stock is considered to be correcting the decline through time and that is a bearish omen for the stock. A correction through time for a stock in a downtrend shows that there is still a source of supply in the stock that prevents prices from rallying. Whether these sellers are establishing short positions or it is long liquidation is irrelevant, the value here is to



**FIGURE 1.28** The downtrending stock shows a series of sell offs followed by rallies that fall short of the prior high. It is these rallies that give short sellers the opportunity to profit in a declining stock.

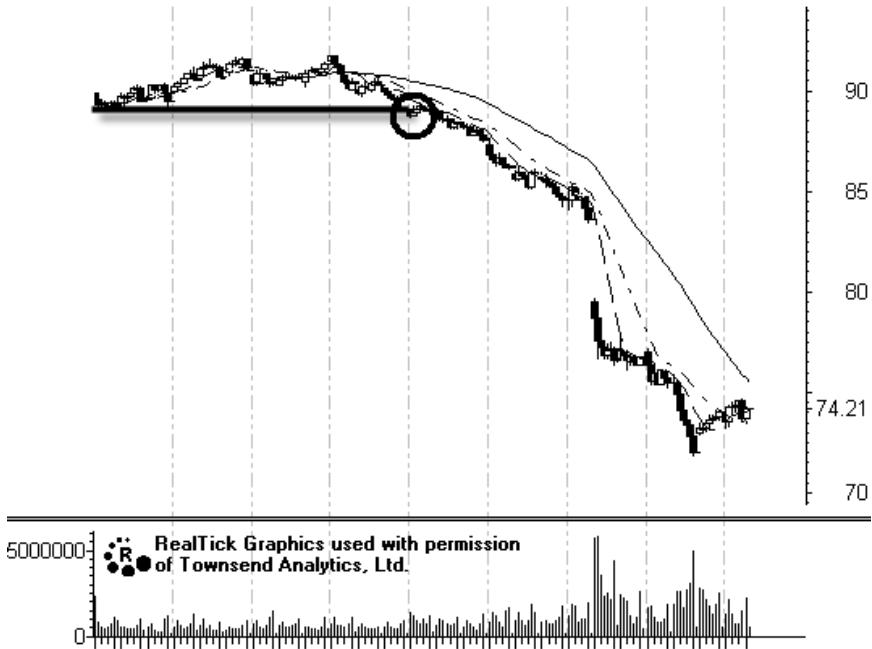
know that there are sellers who are preventing the stock from making any move back up. A correction through time will not typically take more than 2 to 5 days for a stock in a downtrend because there is still a healthy amount of fear in the stock and long holders will become frustrated and begin to liquidate their positions once it becomes clear the stock is unable to rally. As the stock breaks back down through the lows of the stabilization near \$40 it represents an ideal time to sell the stock short. (See Figure 1.29.)

Just as we do not want to short Stage 2 stocks, there is rarely a good reason for getting long a stock that is in a Stage 4 downtrend. By its very definition, a downtrending stock assures us that there are more opportunities to profit by selling short than going long. The sum of the declines will always be greater than the sum of the rallies in a downtrend. Once a stock has been identified as being in Stage 4 (the Profiler can help save a lot of time with this task) the trader should then seek out a low risk entry price.



**FIGURE 1.29** As a stock in a downtrend progresses lower it does so by making lower highs and lower lows, which means the sum of the short-term declines will always be greater than the sum of the short-term rallies. This is the primary reason we do not want to attempt to purchase stock for the short-term rallies when the primary trend is established lower.

Intraday (6U-MIN) MA8 MA13 MA21



**FIGURE 1.30** This 60-minute time frame allows us to recognize where the sellers regain control of the short-term trend as the stock broke below \$87.00. This shorter-term time frame allows us to enter the primary downtrend just as the stock begins a new short-term decline.

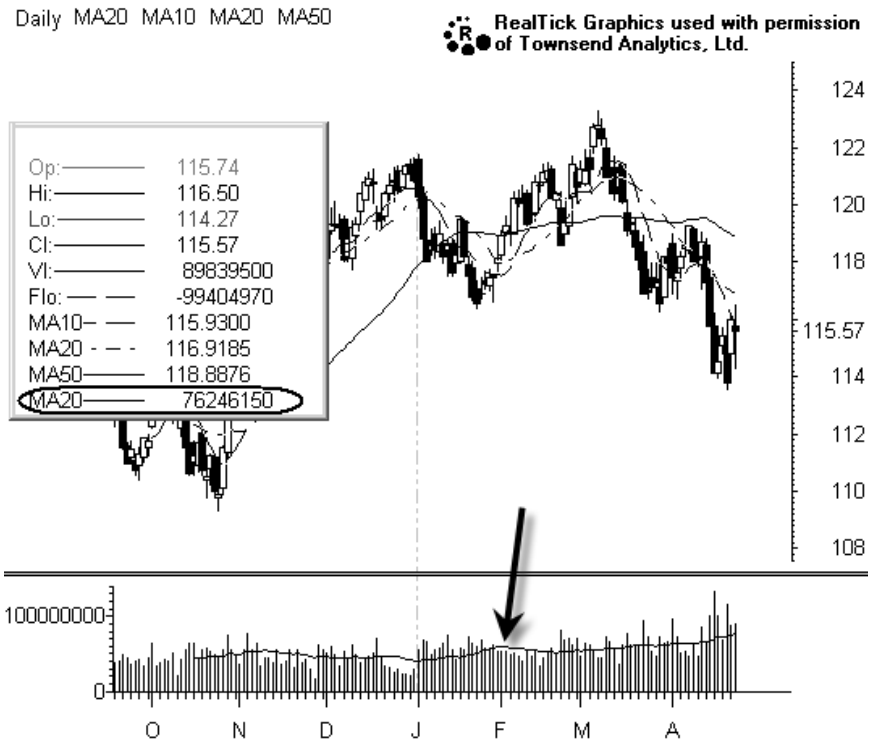
This is accomplished by utilizing a short-term time frame like the 60-minute chart in Figure 1.30. The ideal time to enter a short position is as the stock transitions from a Stage 3: Distribution to Stage 4: Decline on the 60-minute time frame. Entering just as the sellers take control of the short-term trend allows us to enter when there is downward momentum that eliminates the time risk. An entry just as the stock enters Stage 4 also provides us with a clear area to set our stop (just above the high of Stage 3 on the 60-minute time frame).

Trends are a foundation of technical analysis and by utilizing them big money can be made; for this reason traders should always trade in the direction of the primary trend. It is easy to get confused by listening to analysts, journalists and even the policy of the Federal Reserve. Your best chances of success will come when you listen to the message of the market and stay focused on trends. Focusing on objective price action will put you at a tremendous advantage to those participants who choose to listen to subjective noise.

## TRADING VOLUME

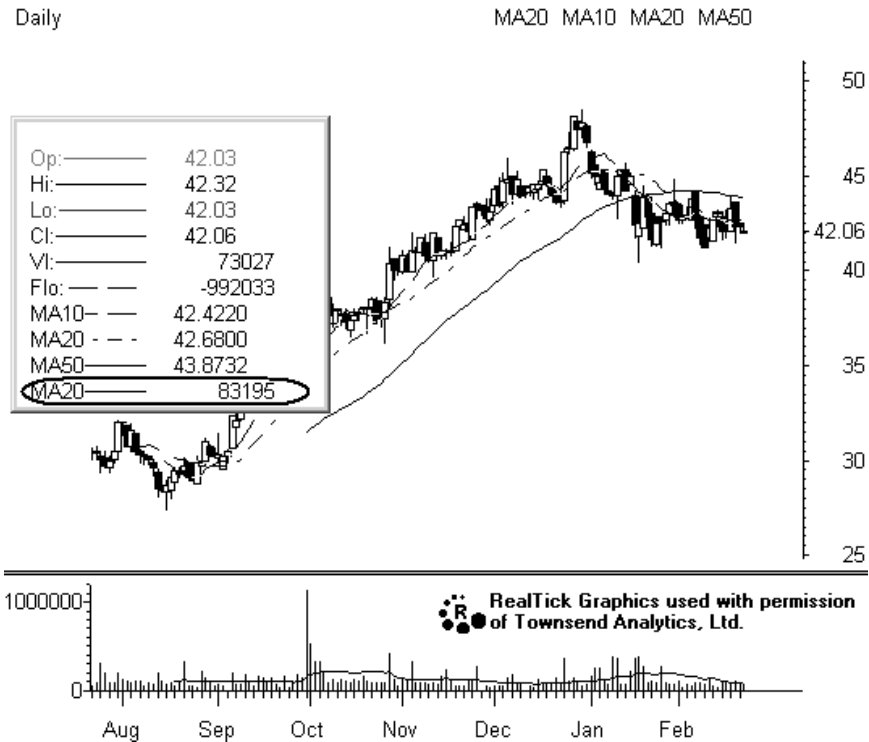
Volume is one of the foundational variables that we consider to be essential to have a thorough understanding of how stocks trade. Volume is the fuel for price movement. What volume really measures is the emotional intensity level of the participants in any market. How committed the buyers are or how fearful the sellers are can be inferred with an understanding of volume. All of our analysis will be focused on what we see on the chart at the present time, the forward looking part is what our analysis attempts to predict. The way that volume is displayed on the chart is shown by a separate vertical scale below price. The volume bars correspond with the candle directly above it, it measures how many shares changed hands during the specified time period in the price range represented by the candle above.

Measuring volume is relative, and it should be done by comparing the current volume to the average volume. RealTick makes it easy to



**FIGURE 1.31** The moving average of volume shows the relationship between the daily volume and the average volume of the last 20 days that allows us to quickly recognize unusual trading activity that may signal we should look closer for a trading opportunity.

see an actual moving average of volume overlaid in the volume field of the chart (see Figure 1.31). I like to look at the average daily volume of the past 20 days. That is also the formula we use in the Profiler volume fields. When you initiate a search for stocks in the Advanced Screener part of the Profiler, the volume fields show a minimum of 500,000 shares to a maximum of 100 million shares per day. Of course, these numbers can be changed but I would warn you against trading stocks that trade less than 500,000 shares per day. Stocks that trade light volume (less than 500,000 shares per day) are referred to as “thin” stocks (see Figure 1.32). A thin stock is one that trades low average daily volume and this alone makes trading them quite difficult at times. It is important to understand that the volume patterns are not spread evenly throughout the day, instead, the market tends to trade the majority (as much as 60 to 70 percent) of its daily volume during the first and last hour and a half of each day. Because the liquidity in a stock is skewed so heavily toward the beginning and end of each day, it can be espe-



**FIGURE 1.32** Only about 80,000 shares change hands each day in shares of this stock, making it a thinly traded stock. Trading thin stocks carries a set of risk factors that make them unsuitable for the majority of market participants.

cially treacherous to trade the low volume stocks during the middle of the trading day. The stocks I recommend traders (especially newer traders) stick to are the stocks that are considered “thick.” A thick stock (see Figure 1.33) is one that trades a large average number of shares each day. The advantages of a thick versus thin stock are primarily one of liquidity; it will be much easier to find liquidity in a stock that trades heavy volume. Having liquidity is one of the biggest advantages stock market traders have compared to investors in other asset classes like real estate or art. Generally speaking, the more active you plan on being in the market, the higher average daily volume you should search for in your trading candidates.

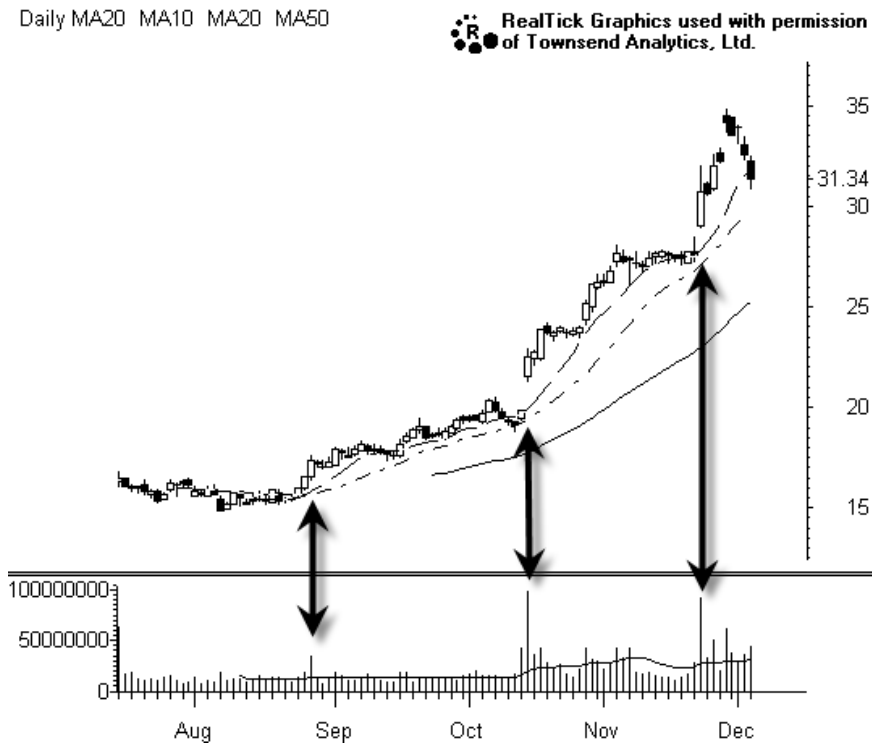
Because volume is the fuel for movement we want to pay careful attention to unusually high volume events. As mentioned in the section about trends, I like to find stocks that experience large volume breakouts



**FIGURE 1.33** A “thick” stock like the one shown here trades tens or even hundreds of million shares each day. These stocks represent potential opportunities for traders of all experience level but are even better for newer traders because they assure the chance to get out of a bad (or maybe even erroneous) position quickly.

from a longer Stage 1: Accumulation. It is the big volume breakouts that seemingly take a large majority of market participants by surprise and gets the most attention, which leads to continued upside movement (see Figure 1.34). When a stock breaks past a level of resistance on large (2 to 3 times its average daily) volume it is often due to a fundamental development that the market was not anticipating. This event causes a sudden shift in perception as to the value of the company and as a result, buyers pile into the stock all at once. The initial large volume breakout should never be sold short; it is like jumping in front of a speeding locomotive and expecting it to be able to stop before running you over. Instead, aggressive traders should closely monitor intraday charts for an entry point the day after the breakout and more conservative traders should wait for either a pullback in price or a consolidation through time before entering the stock.

Large volume breakdowns are no different, they represent an immediate desire for a large amount of participants to exit a stock and when you see a stock gap down by more than 5 percent on large volume, that stock is

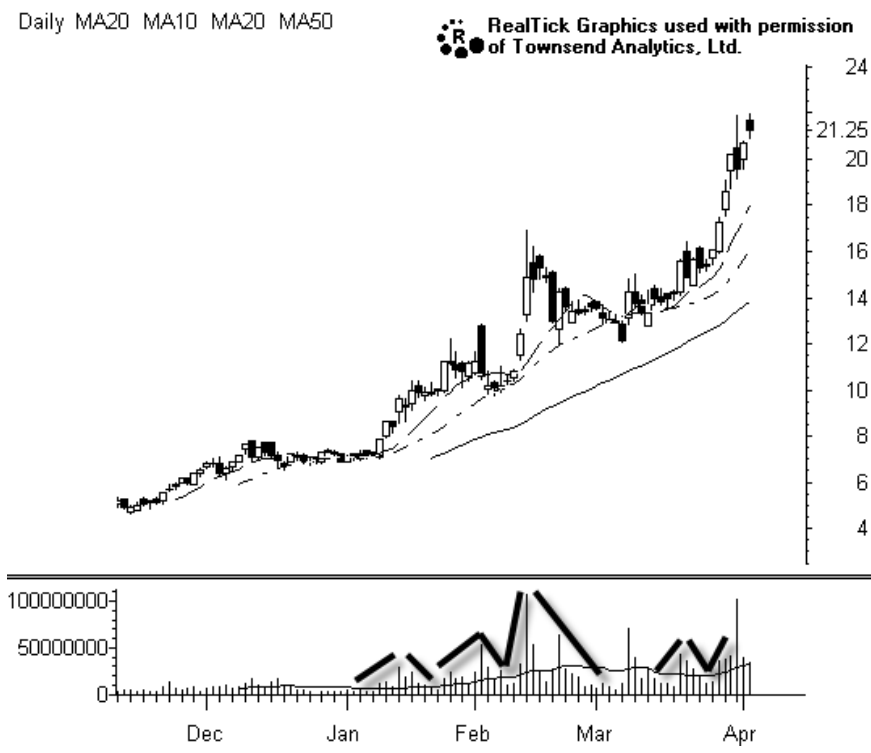


**FIGURE 1.34** The high-volume spikes with large price movement signaled the beginning of short-term trends numerous times in this stock.

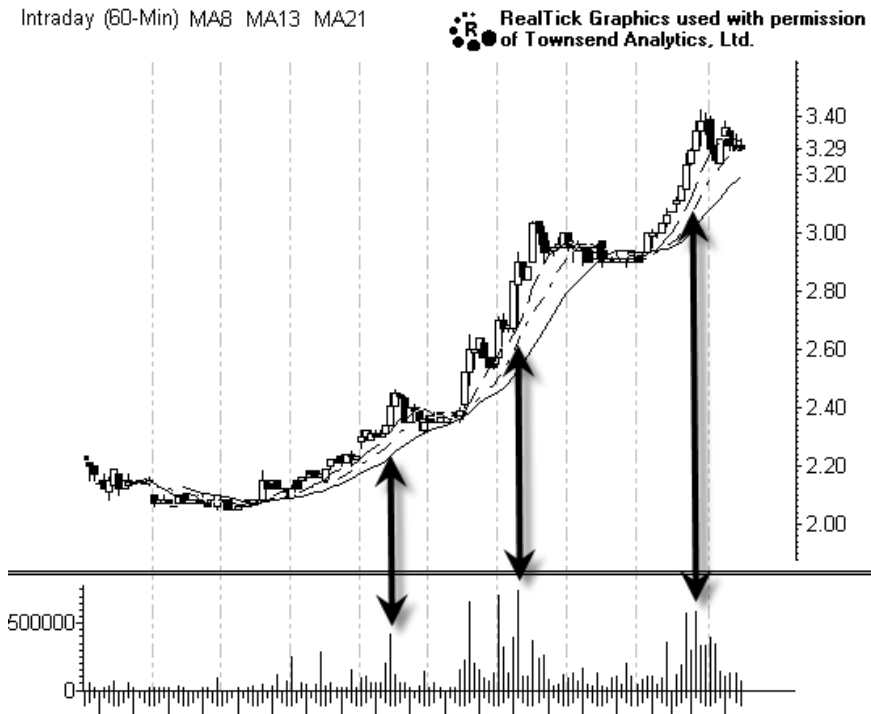
one that will usually continue to experience weakness over the coming months. Many traders make the mistake of purchasing the stocks that gap lower, anticipating the stock will bounce higher. The sad fact is, this is a strategy that I have seen eat through the account equity of many smart people. Whenever there is a rush or stampede out of a stock, it is usually for a very good reason. When we listen to what the market is saying, the big volume events are like the market shouting its message to us, do not ignore what the market is saying.

We pointed out the value of a moving average for volume is to determine whether the liquidity is sufficient for trading a particular stock and that is not the only instance where we will use a moving average to find a relative volume measurement. When stocks are trending, there is a very distinctive pattern that is left on the chart.

In an uptrend (see Figure 1.35), the volume should advance as the stock moves higher and diminish on the corrections (either by price or



**FIGURE 1.35** Notice how this stock advanced on increasing volume and then the volume diminished as the stock corrected either by price or through time. Many of the highest volume days also came toward the end of the short-term move.



**FIGURE 1.36** Big volume without further upside progress equals distribution. Traders should be alert for unusual volume after a stock has experienced a short-term move because it often signals a potential reversal could be at hand.

through time). The increasing volume as the stock advances sends a clear message that buyers are anxious to own the stock. In an uptrending stock, the largest spike in volume typically comes near the end of the move when a large source of supply is brought into the market that halts the upward movement (see Figure 1.36). The relatively light volume found in the short-term corrections also sends a clear message; the sellers are not rushing out of the stock. This message speaks to supply and demand, demand is strong and supply is low. The low volume pullbacks should be monitored closely for opportunities to buy the stock as it begins to move higher on the shorter-term time frames.

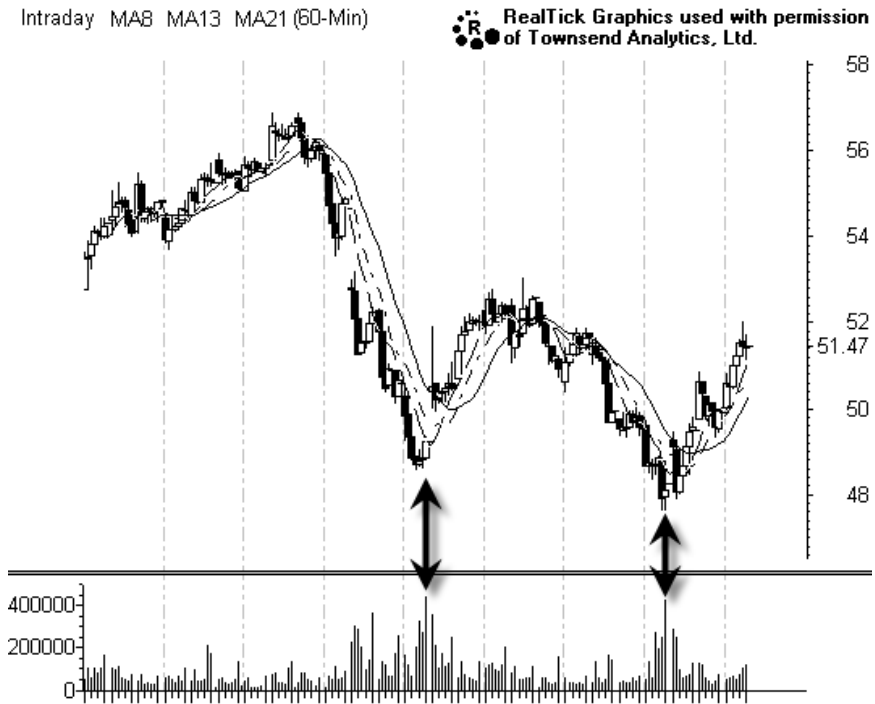
In a downtrend, the volume will also expand in the direction of the trend and then diminish as the stock experiences its short-term rallies or corrections through time (see Figure 1.37). As the stock begins its move lower there is often a sense of denial amongst long holders who convince themselves it is okay to hold the stock because the volume is light on the sell off. This is a terrible reason to continue to hold the stock long. Volume



**FIGURE 1.37** The volume in a downtrend increases on the short-term declines (think heavy fear) and then diminishes as the stock experiences a short-term rally within that primary decline. Also notice that many of the highest volume spikes came toward the *end* of a short-term decline.

is used for confirmation of price, not a reason to trade. After the stock has declined for one to two days, the volume typically starts to become heavier until it reaches a frenzy (see Figure 1.38). It is quite common for the largest volume to come at the end of the move when news quite often comes out and gives sellers a “reason” for the weakness. The increasingly heavy volume as the stock sells off indicates sellers are getting more aggressive while the diminishing volume of the correction tells us that buyers are not in a hurry to own the stock. This message of increased supply and decreased demand should be recognized for opportunities to sell short as the stock transitions from Stage 3 to Stage 4 on a 60-minute time frame.

Volume is a confirmation tool that allows us to gauge the likelihood of trend continuation where there is an established Stage 2 or Stage 4. Interpretation of volume in Stages 1 and 3 is more difficult for assisting us in finding good trading candidates but it does have its occasional uses. Consider a stock in a Stage 1 pattern, as the stock reaches the high end of the range, increasing volume could be a sign that a breakout could be



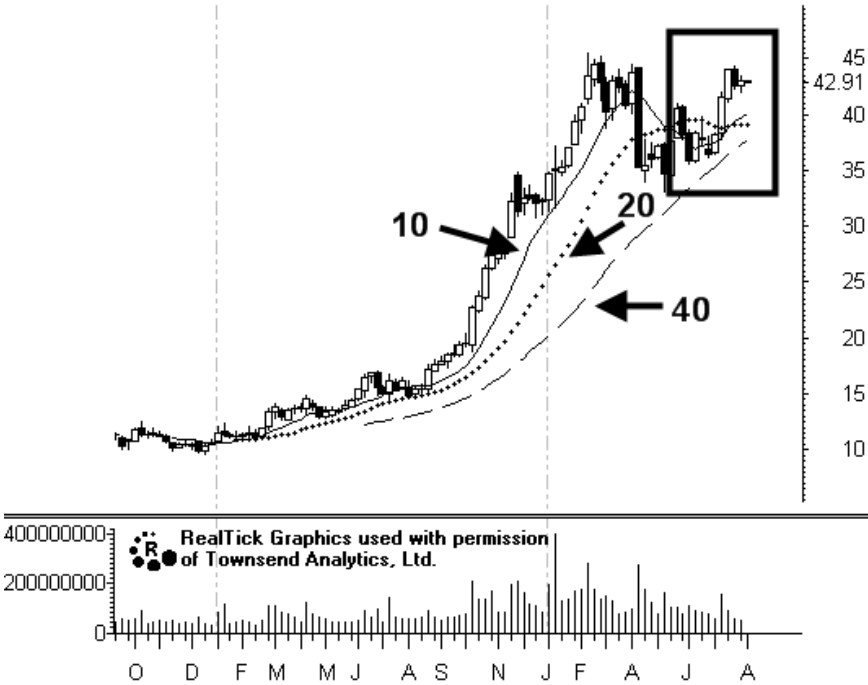
**FIGURE 1.38** Heavy volume without further downside equals accumulation. It is common for short-term reversals of a downtrend to come just after the stock experiences a fearful sell off, as the source of supply becomes exhausted.

imminent, particularly if it is a Stage 1-3 (late accumulation). As far as actual tradable signals go, the only thing that would alert us to purchase a stock in Stage 1-3 is the actual breakout to Stage 2. Be sure to use volume as a confirmation tool, it is not meant to provide us with entry or exits, only price can do that.

## MOVING AVERAGES

The purpose of a moving average (MA) is to smooth out price trends by calculating the average closing price over a given number of periods of time. For instance, when referring to a 10-day MA, it represents the average closing price over the past 10 days. An 8-period MA on an hourly chart would represent the average closing price over the past 8 hours. The moving averages referred to in this book and on the Profiler are simple moving

Weekly MA10 MA20 MA40

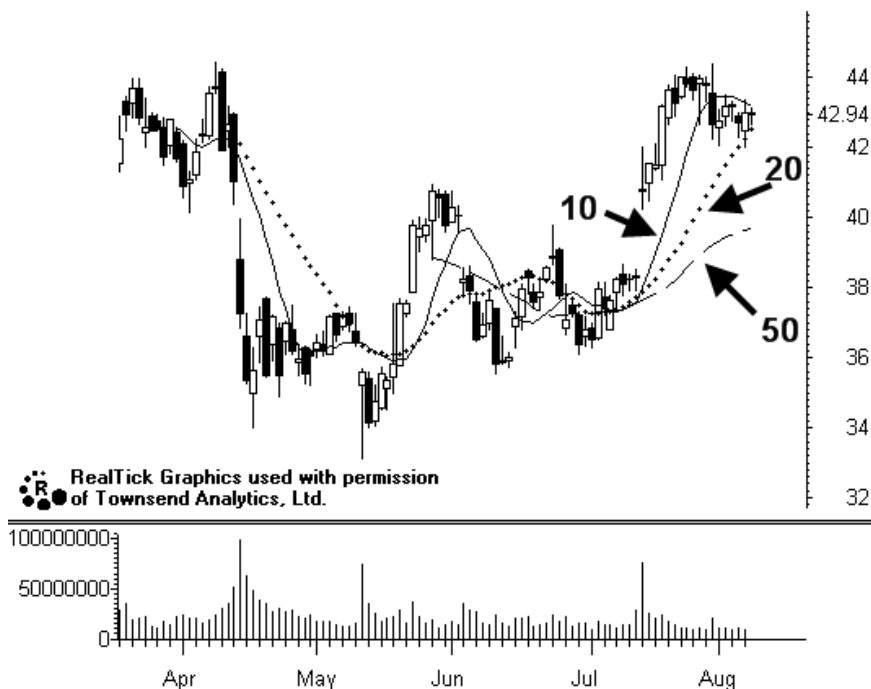


**FIGURE 1.39** This weekly chart shows the 10- (solid line), 20- (dotted line), and 40- (dashed line) week moving averages laid over price.

averages. It is important to point out that besides the simple moving averages, there are exponential MAs, volume weighted MAs and a lot of other ways to complicate a simple concept. Because we use moving averages as a reference point to compare trend to, rather than as an outright trading system, it does not make much difference if you were to substitute an exponential MA with the simple MA. Too much attention has been focused on which MA is better, the simple or the exponential, and in our significant back testing, we have found no advantage to either one. We choose to use the simple MA because that is what most market participants look at and when attempting to anticipate human behavior we want to have a feel for what the majority of participants are basing their decisions on.

Moving averages are laid directly over price in the upper portion of a chart (see Figure 1.39). The moving average can be thought of as a mathematical trend line that self adjusts when new data replaces older data as the market provides us with new trade information. The way that I like to look at MAs is to have three different ones for each time frame I am

Daily MA10 MA20 MA50

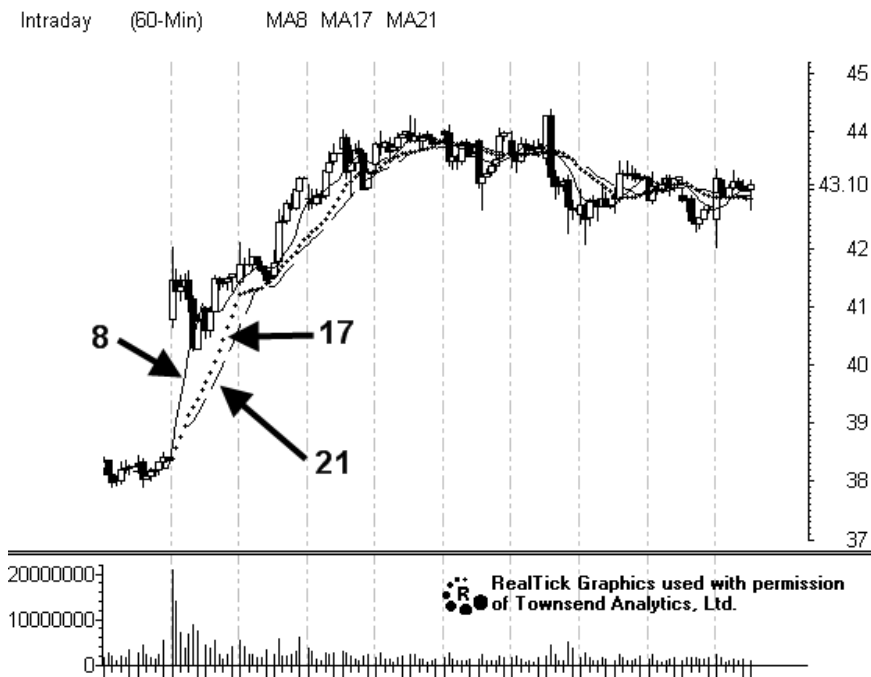


**FIGURE 1.40** This daily chart shows the 10- (solid line), 20- (dotted line), and 50- (dashed line) moving averages overlaid on price.

considering in my analysis. By having three different MAs on the chart, I can quickly ascertain the short-term, intermediate-term, and longer-term trends of the time frame being studied. Starting with a long-term time frame that displays weekly information, I like to look at the 10-, 20-, and 40-period MAs as reference points for the trends of the stock (see Figure 1.39). These MAs are excellent representatives of trend for this long-term time frame and should be used for investors who wish to be involved in trends. Also note that the 10-week MA represents the average closing price for 50 days, the 20-week is the same as a 100-day MA and the 40-week MA is equal to the 200-day MA.

When analyzing price data on a daily chart, I begin with a chart that covers 150 days. On the chart in Figure 1.40, the MAs that are most widely followed are the 10-, 20-, and 50-period MAs. These three MAs offer the best views of the short, intermediate, and long-term trends.

When it comes to fine tuning entries and exits for swing trades, using intraday time frames allows us gain greater clarity of the developing

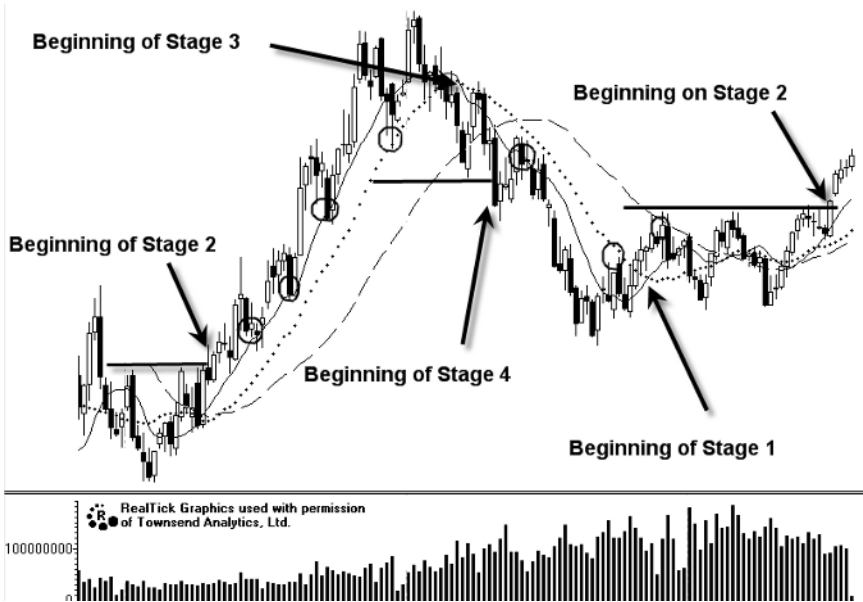


**FIGURE 1.41** This hourly chart shows the 8- (solid line), 13- (dotted line), and 21- (dashed line) moving averages overlaid on price.

trends. The time frame I use to find the granularity necessary for entries and exits is the 60-minute time frame. A chart with hourly bars (see Figure 1.41) can help identify support and resistance levels that may not be visible on a daily time frame which allows us to attain entry and exit prices that might improve our executions by as much as \$.20 to \$.50 per share. On the hourly time frame, we have done extensive back testing of various MAs to find the ones that follow trend best and those are the 8-, 13-, and 21-period MAs. On this short-term time frame, these are the MAs that offer the best visual reference point for short, intermediate and long-term trends.

Now that we have an understanding of which MAs to use on each time frame we will explore how they can help us in our analysis. To reiterate, we do not use MAs as a trading system, they are merely an objective reference point to compare price to. In the Profiler, we have broken each of the four stages into three substages, and a large part of the stage and substage placement is determined by the MAs we have referenced.

Looking at Figure 1.42, we will now learn how the MAs can be utilized to identify which stage a stock is in. I have purposely removed all reference



**FIGURE 1.42** This chart shows the transition between stages and how moving averages can assist us in determining which stage a stock is in.

to time and price for this example because the concepts apply to any time frame. The first thing you should notice about this chart is the cyclical movement through all four stages (which are noted on the chart). Starting on the left side of the chart where it states “Beginning of Stage 2,” we will examine how the MAs help us determine which primary and substage the stock is in. As the uptrend begins, you will notice that there are several circles where price meets the rising short-term MA. When the stock price is above all of the MAs with the short-term MA above the intermediate-term MA and the intermediate-term MA above the longer-term MA, the stock is considered to be in Stage 2-1 (strong uptrend).

It is quite common for the short-term MA to act as a support level for the stock. This needs to be explained further. You are probably wondering why a MA would act as support and the reason is simple, *perception*. Because MAs are viewed by so many participants as support levels, there tends to be a lot of trade activity centered near the MAs. When a stock in a primary uptrend starts to undergo some profit taking, the sellers will often cease selling as the stock reaches the short-term MA because they know there is usually support in that area, this lessens supply available near the MA. There is another group of participants that may be looking for an entry into this trending stock and recognizing a pullback to a short-term MA, they place bids at a level near the MA, and this creates demand. The lessened action of the sellers coupled with the more aggressive bids creates a situation where prices

begin to find support after the short-term pullback. At this point, you may be thinking that you too should place bids near this MA. Wrong! When the stock reaches the short-term MA, we should start *acting like a buyer* but not make any actual purchases until we have studied a shorter-term time frame.

Suppose this chart is a daily time frame, when the stock pulls back to the short-term MA, we then want to put our analysis under a microscope and study the hourly time frame which should show the stock in a Stage 1. The picture on the longer-term time frame will be a solid Stage 2 uptrend but the short-term trend is now neutral. What we want to do is to watch the stock closely for further signs of strength on the hourly chart and buy just as the buyers gain control of the trend again. This allows us to be in the stock when there is momentum; we are then in the stock from a position of strength.

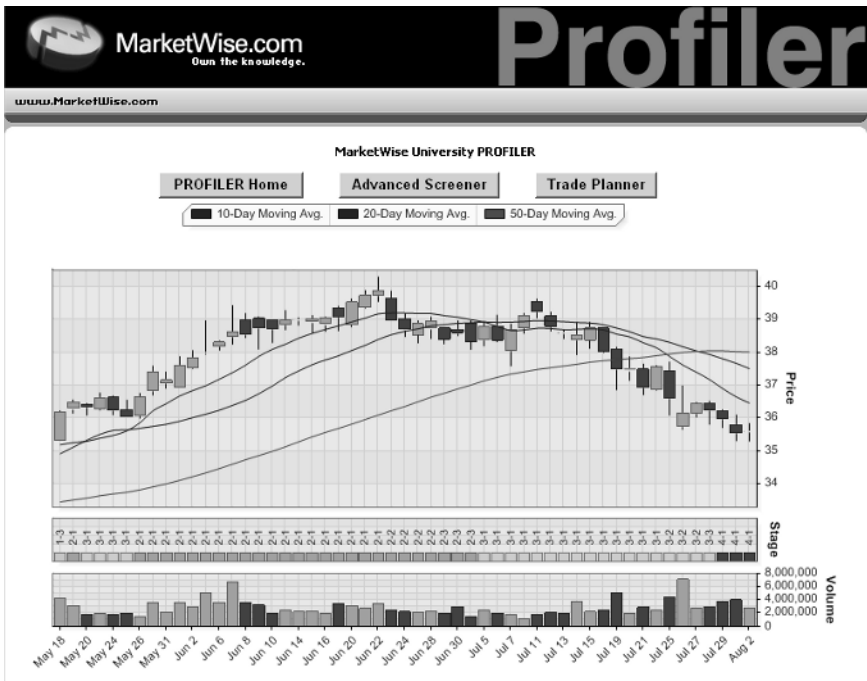
Moving further along the uptrend, you will notice as the trend becomes more mature, and after numerous tests of the short-term MA, the stock experiences a sharper break down to find support near the rising intermediate-term MA. This area, between the rising short-term and intermediate term trend is known as “medium markup” and is referenced in Profiler as Stage 2-2. Soon after the stock finds support at the intermediate-term MA, the pullbacks become even deeper with support found near the longer-term MA. When the stock finds support at the longer-term MA, it is considered late in the uptrend and is labeled as Stage 2-3.

The next area to note in Figure 1.42 is the area labeled “beginning of Stage 3.” You will notice that the arrow points to where the short-term MA crosses down through the intermediate-term MA. When this occurs, the market is sending mixed messages to us. The message is mixed at this point because it is saying; short-term trend is lower, while the intermediate- and longer-term trends are still higher. While we can never have absolute certainty in the market, when the market is sending us mixed messages we want to stay away from the action. You have heard the phrase “when in doubt, stay out.” When there is indecision (as represented by MA crossovers) on the chart following an uptrend, the stock is considered to be undergoing distribution. Stage 3 stocks are typically marked by diminishing volatility as the sellers gradually gain control of the stock. Put simply, moving average crossovers represent indecision and are a reason to stay out of the market.

As the stock breaks down below the low of Stage 3, the next point on the chart is labeled “beginning of Stage 4.” In order for the stock to be in a Stage 4, there of course has to be a pattern of lower highs and lower lows. The way the Profiler algorithmically sorts the Stage 4 stocks is by using the following criteria. The short-term MA must be below the intermediate-term MA and the intermediate-term MA must be below the longer-term MA. Further, while price is below the short-term MA, the stock is considered to be in a strong downtrend (Stage 4-1). Just as the short-term MA will often act as support in an uptrend, the short-term MA will often act as resistance during the strong part of a decline. When you see a stock rallying up to the

short-term MA in a primary downtrend that should be your clue to look for weakness on a shorter-term time frame, which is the best time to initiate new short positions. As the stock progresses in its downtrend you will notice that resistance is often found near the intermediate MA (Stage 4-2) and then the longer-term MA (Stage 4-3). Although the longer-term MA acted as resistance after the point labeled as the beginning of Stage 1, rallies should never be trusted while the longer-term MA is still declining. As mentioned earlier, a declining longer-term MA indicates a stock that is “guilty until proven innocent” while an ascending longer-term MA indicates a stock that is “innocent until proven guilty.”

Stage 1 begins similarly to Stage 3; it is a moving average crossover that indicates indecision and the likely end to the downtrend. Remember that the end of the downtrend does not mean we should purchase the stock, as the most likely path of the stock is for reduced volatility as the buyers slowly wrestle control from the sellers. The specific beginning to Stage 3 is the crossing of the short-term MA up through the declining intermediate-term MA. Once this crossover has occurred the next short-



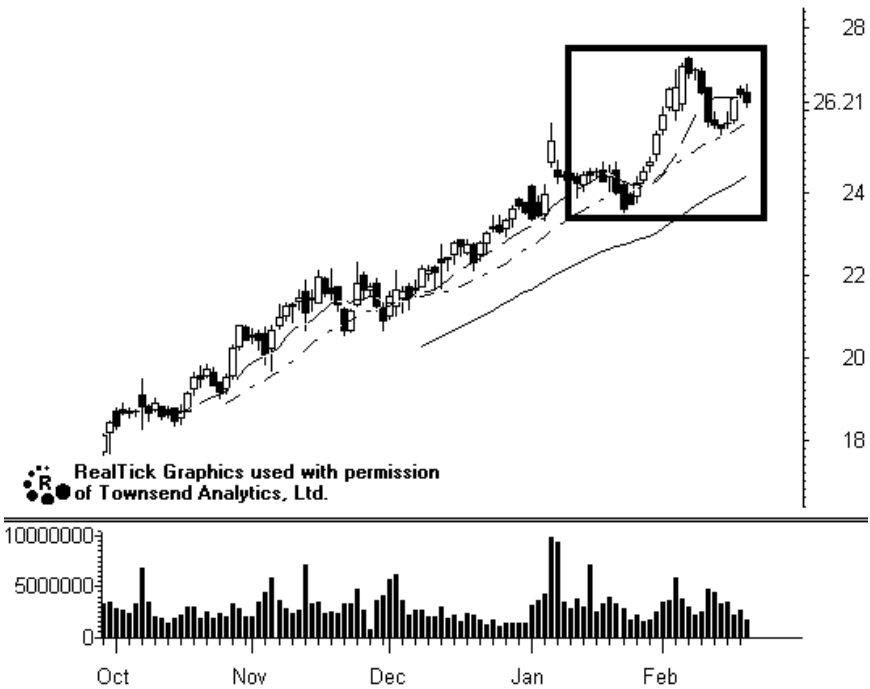
**FIGURE 1.43** The Profiler charts visually represent not only price, volume and moving averages, but they also show the primary and substage for every stock.

term high marks the high of Stage 1, a level that will have to be eclipsed for the stock to enter Stage 2 and repeat the cycle again.

A unique and helpful tool in the Profiler is found on the price charts embedded in the application. Looking at the chart in Figure 1.43 you will notice that besides price, the chart shows the 10-, 20-, and 50-day MAs on the upper section. Just below the price area you will see an indication of which stage the stock is in. The stage analysis drawn onto the chart allows you to see exactly which primary and substage the stock is in as well as for how long. This feature allows you to speed up your learning curve for objective trend recognition that ultimately will help you find the ideas that meet *your* criteria.

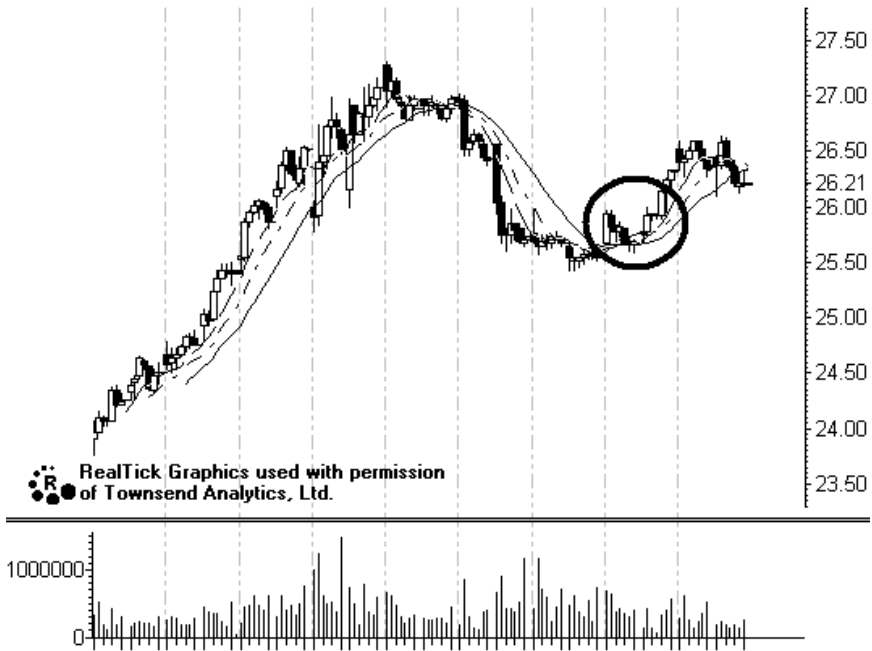
Figures 1.44 and 1.45 are examples of a long setup, and Figures 1.46 and 1.47 are examples of a short setup using a daily and hourly time frame together for attaining the ideal entry price. As has been repeated, we want to find our trading ideas on a longer-term time frame. Once we have identified the powerful long-term trend, we then want to use the short-term time frame to capture precise entry points into that longer-term trend.

Daily MA10 MA20 MA50



**FIGURE 1.44** The boxed in area of this Stage 2 stock on a daily time frame is shown in more detail in Figure 1.45. Notice how the stock found support just above the rising 20-day MA.

Intraday (60-Min) MA8 MA13 MA21



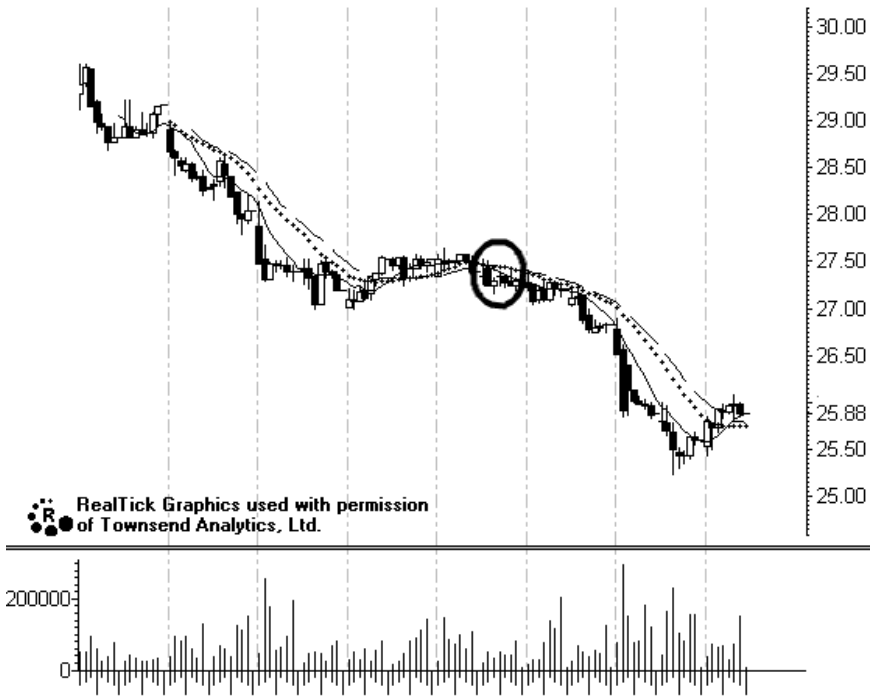
**FIGURE 1.45** This hourly chart shows the rally from 47 to 55 in greater detail. The circled areas represent the ideal entry points—that is where the buyers have regained control of the short-term trend.

Daily MA10 MA20 MA50



**FIGURE 1.46** Using the same concept for a short sale, we will examine the boxed in area of this daily downtrend in more detail in Figure 1.47.

Intraday (60-Min) MA8 MA17 MA21



**FIGURE 1.47** This hourly time frame allows us to refine our analysis so we are entering our short positions as the sellers take control of the short-term trend. The circled area shows where the ideal short sale should have been entered.