July 2011 Edition

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Letter from the Editor

This issue contains a few more summaries of MTA Symposium speaker presentations. There were two other presentations that no one should miss, but are in some ways too important to offer in summary form.

The Technician’s Technician Panel brought together the technical analysts employed by the largest firms. Jordan Kotick, CMT, Managing Director and Head of Technical Trading Strategy for Barclays Capital, led the discussion and shared the stage with:

- Richard Adcock, MSTA, Executive Director, Fixed Income Technical Strategy (London), UBS
- Mary Ann Bartels, Head of US Technicals and Market Analysis, Bank of America Merrill Lynch
- Muray Gunn, CFTe, Head of Technical Analysis, HSBC
- Michael Krauss, Managing Director and Head of Global Fixed Income Technical Analysis, J.P. Morgan Securities
- Tom Pelc, MSTA, CFTe, Head of Technical Strategy, RBS Group
- David Sneddon, Managing Director, Credit Suisse

While their market views and favorite techniques differ, all of these esteemed analysts share one opinion. They agreed that technical analysis is in a bull market and opportunities are more plentiful than ever in this field.

Always popular, the Market Forecast Panel brings several distinguished technicians together to discuss what they see in the markets and how they think the future will unfold. Rather than trying to present the views of Ralph Acampora, Dr. Hank Pruden, Ken Tower and Chris Cady into simple bullish or bearish calls, the video of this discussion should be watched in full. What is most important is the thought process that some of the greatest minds in technical analysis apply to formulate their opinions. Each uses a different approach, and each has attained a great deal of success with their technique.

As we work on future issues, we would like to hear what is important to you, our readers. Please let me know what you’d like to see in upcoming issues. The MTA Directory lists my phone number, or email editor@mta.org.

Sincerely,

Mike Carr, CMT
MTA Annual Award for 2011 Recognizes Richard Donchian

The Annual Award is issued to a person who made an outstanding contribution to the field of technical analysis. This year, Richard Donchian, a pioneer in the field, was recognized by the MTA. He is probably best known among market technicians for developing the four-week rule. This trading strategy buys when prices reach a new four-week high and sells when prices reach a new four-week low. The system is always in the market, long or short.

Donchian had a very successful career, which is summarized in his biography at the web site of a charitable foundation he founded (http://www.foundationservices.cc/RDD2/aboutus.htm).

Richard Davoud Donchian was born in Hartford, Connecticut, in September, 1905, the son of Samuel B. Donchian and Armenouhi A. Davoud, both of whom migrated from the Armenian province of Turkey in the 1880’s. Richard attended public schools in Hartford, the Taft School in Watertown, Connecticut, and graduated from Yale University in 1928 with a BA degree in economics. Upon graduation, he entered the family's Oriental rug business.

Although he appreciated studying about and collecting Oriental rugs, he became more interested in the financial markets after reading the book about Jesse Livermore, Reminiscences of a Stock Operator. After suffering personal financial losses during the market crash of 1929, he began his study of technical analysis, believing that only the chartists made sense and money. While continuing to serve as a Vice President of the Samuel Donchian Rug Company, he became a securities analyst and account executive with Hemphill, Noyes & Co. in 1933.

During World War II, he participated in the invasion of Sicily and later served as an Air Force Statistical Control Officer in the Pentagon. After the war he returned to the world of investments as a private investment adviser and economic analyst, remaining self-employed until 1960. In 1948 his focus changed from securities to the trading of commodities. He created "Futures, Inc.,” a pioneer publicly held commodity fund, based on the principle of diversification, an idea new in this field. He was later dubbed the 'father of modern commodities trading methods,' having developed a technical trading method called trend following, which presupposes that commodity prices will move in long sweeps like bull and bear markets. He used a mathematical system based on moving averages of commodity prices. During this period, he authored numerous articles on both securities and futures trading.

In 1960 he became associated with Hayden Stone Inc., as Director of Commodity Research. From then until his death on April 24, 1993, he was associated with the various configurations of Hayden Stone and Shearson Lehman Brothers, as a Senior Vice President. Also in 1960 he became responsible for writing a weekly technical newsletter entitled "Commodity Trend Timing," which he continued to author for 19 years. In 1963 he was awarded a Chartered Financial Analyst degree from the Institute of Chartered Financial Analysts at the University of Virginia.

Mr. Donchian was best known for his pioneer work in the field of commodity futures money management. He was a member of the Commodity Exchange, Inc., the New York Cotton Exchange, the New York Futures Exchange, the New York Society of Security Analysts, the American Statistical Association, the National Association of Future Trading Advisers, the Financial Forum, and listed in Who's Who in America. In June 1983 “Managed Accounts Report” selected him as the first recipient of its “Most Valuable Performer Award,” for outstanding contributions to the field of commodity money management.

His life's work continues through a charitable foundation. The Richard Davoud Donchian Foundation was founded after Mr. Donchian's death in April of 1993. Extending Mr. Donchian's lifetime passion, its mission is to help others meet their potential and achieve high degrees of personal and professional success. Richard Donchian was an American of Armenian descent, with an unquenchable desire to share with others the rewards of his professional life, not only with those of his native country, but with the people of his ancestral country as well.

The Foundation emphasizes that throughout his life, Donchian displayed compassion and humility. His faith and his character were never open for compromise. His dedication to each continues to influence the form and substance of Mr. Donchian's giving legacy.

The Foundation's Board of Directors is continuous in its efforts to preserve the Donchian legacy of leadership & integrity, as well as its commitment to learning and personal growth. Consequently, the Foundation concentrates its primary giving activities in the areas of ethical leadership in business and community affairs; education, personal development and literacy; and moral, ethical & spiritual advancement in all areas of life.

To learn more about the Foundation, please visit, http://www.foundationservices.cc/RDD2/index.htm

MTA Annual Symposium: Applying Timing to Global Markets by Tom DeMark

Summarized by Mike Carr, CMT
Tom DeMark is a well-known and widely followed market timer. During his career, the Dow Jones Industrial Average has traded below 600 and higher than 14,000 so he is a veteran of bull and bear markets and has endured years of sideways action as well. In his talk, he offered a few reflections based upon what he has seen in the markets over the past 40 years.

As he began working in the industry, Tom was following a typical career path. He began as an analyst at NN Investment services, a subsidiary of Northwestern National Insurance in January 1972. He began studying for the Chartered Financial Analyst (CFA) exam, and he commented that he had completed the C and F before realizing he wasn’t getting as much out of the program as he had hoped. Technical analysis was interesting and seemed as a practical approach to making money, and his firm supported learning as much about the subject as he could.

In the early 1970s, Tom began an education process by seeking out the very best technical analysts and discussing their work. He was able to meet many of the early members of the MTA this way, and he also spoke with Hamilton Bolton and Jack Frost about Elliott Wave. There was very little information about technical analysis in general at that time, and even less about Elliott Wave. Tom spent many hours locating experts, only to find they had little to offer in the way of practical applications despite some having a lot of entertainment value. He met people who felt Elliott must work because they had been married 5 times and had 8 children, or cited other variants of Fibonacci numbers in their lives. Despite the look fringe that existed in the field, Tom continued in his pursuit of the Holy Grail.

He found that technical analysis often conjured negative images among the investment community, and he repackaged his work as market timing. This allowed him to gain receptive audiences in some cases. His market timing work included a generous amount of typical technical analysis. Tom studied every indicator described in the literature. However, Tom found that many of the traditional technical tools didn’t always work as well as some simple adaptations would. For example, he found trendlines to be useful, when drawn properly. One problem technical analysts have with drawing trendlines is the subjective nature of identifying significant tops and bottoms to connect with the line. Given a chart, any number of trendlines could be drawn and considered to be correct.

Tom described an objective means of drawing trendlines in his 1994 book, “The New Science of Technical Analysis.” He draws them from right to left, instead of using the more traditional approach of starting from older data and drawing towards the right side of the chart. In an uptrend, the two most recent lows are connected with a line. A low is defined as a swing low, which is a bar or candle with a low lower than the low on the bars or candles surrounding it. Trendlines drawn this way can also be used to identify price targets once they are broken. Targets are obtained by noting that a degree of symmetry is often visible in price action and expecting to see a move below the line equal to the move that occurred above the line.

This is a simple concept to understand, and eliminates much of the confusion from traditional trendlines. The idea of applying symmetry to identify price targets is found in traditional chart pattern analysis and is the basis of finding targets with a head and shoulders pattern, rectangles, and several other patterns.

Thinking about what prices are really telling us is a hallmark of Tom’s analysis. Over the course of his career, he has developed a number of indicators to help anticipate price action, and these indicators start with an underlying logic. First, he looks at what is happening and then applies techniques to quantify the behavior and take advantage of historical patterns. Perhaps his best known indicators are the DeMark Sequential, which seek to identify severely overbought or oversold markets. The logic is simple – large traders will always need to buy weakness and sell strength.

The general rules for this indicator are found in Tom’s books, but there are a number of detailed rules defining this indicator. It is widely available on professional software platforms and the DeMark Sequential is an indicator that is followed by a number of traders. (Editor’s note: the following simplistic rules are a broad description intended to illustrate the idea. They are not Tom’s exact rules and no one should trade based on this simplistic illustration. As noted, the detailed indicators are widely available.)

For a sell signal, the DeMark Sequential is looking to identify an extremely overbought market. Traders tend to get carried away, and markets reflect this. A number of studies have shown that market overreactions occur and there are an increasing number of behavioral finance theories that try to explain this. Years ago, Tom chose to quantify extreme price action and this indicator is considered by many to be a valuable tool for that.

The DeMark Sequential begins with a setup. For a sell signal, on a daily chart, the setup involves identifying nine consecutive daily price closes which are higher than the closes four days earlier. The setup is useful in identifying an initial trend.

Once the setup is complete, the countdown begins and is moved higher each time prices close above the close two days earlier. When the countdown reaches 13, a sell signal is given after the price closes lower than the close four days earlier. This is a very general outline of the idea and there are a number of important qualifiers to determine if the signal should be taken or not.

On a chart, the DeMark Sequential can be seen below. The 9s and 13s are often significant and can easily be incorporated into a trading plan.
In his presentation, Tom offered a number of examples of his indicators. They can be applied over any time frame, and in any market. One unique example was the chicken wing market where a top was marked by a count of 13. He also showed that they can be used on economic data.

It is not surprising to see that DeMark Sequential indicators can be applied in different markets, or to economic data. The indicators were developed to identify overbought and oversold conditions. By trying to find data that has moved too far from its mean, the indicators are quantifying price and time extremes. Mean reversion can be seen in market prices and in many economic data series. By beginning with sound underlying logic, Tom developed timeless indicators. There are a number of variations that can be applied to this indicator. There are also a number of additional qualifiers that limit the risk and help identify only the best trading opportunities. The signals are not 100% accurate, but are helpful to traders.

Understanding all the rules and qualifiers is important to successful trading. Tom demonstrated this with an example related to breakout trading. Using simple 40-days highs or lows to generate trading signals is an example of the well-known trading strategy, often called the Donchian Rule. Testing usually shows this strategy can be profitable over the long-term, with about a third of the trades being winners. Tom tested a simple idea to make the system better – only take long trades if the breakout has been preceded by a down close and short trades would require an up close before the signal. This simple qualifier can almost double the number of winning trades.

In his decades-long career, Tom has identified a number of other interesting tools to help traders. He finds that at least three quarters of the time, any given market will not show any trend. His work has shown that markets do spend more time in uptrends than downtrends, an insight that can be valuable. Traders can give back a large amount of profits by holding onto a position too long in a bull market.

Tom also pointed out that markets bottom because of a lack of selling. This may sound obvious, but it allowed him to develop another tool to help time markets. He defines buying pressure as:

\[
\frac{(C-O)}{(H-L)} \times \text{volume}
\]

Where \(C\) = close, \(O\) = open, \(H\) = high, and \(L\) = low

Buyers are driving the prices when the close is greater than the open and sellers are in control when the close is below the open.

Tom tracks the rate of change of the ratio of buying pressure to the sum of buying and selling pressure. Over time, the 5-day, 8-day, and 13-day rate of change indicators will help identify market turning points. By tracking who is moving prices, the buyers or sellers, traders are in a position to anticipate the turns.

DeMark studies and indicators are followed by traders and analysts around the world. Throughout his career, Tom has focused on defining objective and mechanical approaches. His goal of anticipating price reversals was a consistent theme of his presentation and his work. For MTA Symposium attendees, the presentation was too short but offered enough ideas to fill weeks of study and testing.

Tom DeMark is the creator of the DeMark Indicators® and the founder and CEO of Market Studies, LLC. Formerly an executive vice-president of Tudor, Mr. DeMark currently serves as special advisor to Steven A. Cohen of SAC Capital Advisors, a role he has held for over 15 years. His resume includes consulting to some of the largest trading institutions and fund managers in the world, including Goldman Sachs, Steinhardt Partners, Loews Corporation, Citigroup Inc, JP Morgan, IBM, Union Carbide, MMM, Soros Fund Management, Omega Advisors, Charlie DiFrancesca, as well as many others.

He has authored three successful books detailing the DeMark Indicators and market timing: The New Science of Technical Analysis; New Market Timing Techniques: Innovative Studies on Market Rhythm and Price Exhaustion; and DeMark on Day Trading Options. These indicators appear on licensed institutional financial software platforms, specifically Bloomberg, CQG, DeMark Prime, and Thomson Reuters.
A sample of a growing list of fundamental and technical courses is shown below. The courses are associated with global destinations and dates, both for open and private client formats. They are produced by various knowledge vendors throughout the world (some listed below). Specific details can be provided by contacting them, or John Palicka (palicka@pipeline.com).

Taught by John Palicka, CFA, CMT

Read More...

Cloud Charts – Identifying Trend Changes in Global Markets
Presented at the MTA Annual Symposium by David Linton, MFTA
Summarized by Mike Carr, CMT

New techniques are always part of the MTA Symposium. Although Cloud Charts have been around for some time, they are still a relatively unknown technique, and the first exposure to the charts for many of the attendees was during David’s presentation. Ichimoku Clouds are based on principles first identified by traders in Japan in the 1930s.

To technicians, a picture is almost always worth a thousand words, and David understood his audience. He began with an example of a Cloud Chart and an explanation of what the chart showed.

Clouds are overlaid on price charts. The key components of the Could Chart are:

- Turning Line – midpoint of the high and low of the last 9 sessions.
- Standard Line - midpoint of the high and low of the last 26 sessions.
- Cloud Span A – midpoint of turning line and standard line shifted forward 26 bars forward.
- Cloud Span B - midpoint of the high and low of last 52 sessions shifted 26 bars forward.
- The Lagging Line – the price line (close) shifted back 26 bars.
The Cloud is the shaded area between the Cloud Spans and is plotted ahead of the current price. Clouds are used to spot trends and trend changes.

- Prices above the cloud are bullish. Long trades are more likely to work at this time.
- Prices below the cloud are bearish.
- When price is in the Cloud, the previous trend is still intact. If prices enter the cloud from the top, then the trend is still considered to be bearish.
- Price completely moving through a cloud is a warning sign that the trend is changing. The change is confirmed when the Lagging Line completely passes through the Cloud.

Cloud Charts offer traders a new tool. David demonstrated that they are useful in multiple time frame analysis, and combined with other indicators can serve as the core of a trading strategy.

David Linton MFTA is Founder and Chief Operating Officer, Updata plc. In 1991, David founded Updata plc, based in London and New York, and now, professional traders and analysts in over forty countries around the world use Updata. He is a well known commentator on financial markets in the UK. He has appeared on BBC television, ITN News, Bloomberg and CNBC finance channels and has written for The Mail on Sunday, Shares Magazine and the Investors Chronicle. He has taught Technical Analysis to thousands of traders and investors in Europe over the last two decades with numerous financial institutions employing him to teach and train their trading teams.

David is a member of the UK Society of Technical Analysis (STA) where he teaches the Ichimoku technique as part of the STA Diploma Course and is a holder of the MSTA designation. He is a member of the Association of American Professional Technical Analysts (AAPTA) and was awarded the Master Financial Technical Analyst (MFTA) qualification by the International Federation of Technical Analysts (IFTA) for his paper on the Optimisation of Trailing Stop-losses in 2008. He is the author of Cloud Charts: Trading Success with the Ichimoku Technique, published by Updata.

To view this presentation from the 2011 Annual Symposium, follow this link: http://go.mta.org/11sdl

Interest Rises Sharply In Penn State Trading Contest

by Bruce Kamich, CMT

Bruce Kamich, CMT, President of the MTA Educational Foundation (MTAEF), provides this brief summary of a recent trading contest for college students that was co-sponsored by the MTAEF.

Penn State's 2011 Smeal College of Business Trading Strategy Competition was sponsored by TradeStation Securities and the MTAEF. Participation rose sharply from last year when just 7 schools entered. This year 22 universities and over 160 students took part in the contest that began March 7.

Students traded three popular ETFs using TradeStation programs. The competitor with the best average rank was deemed the winner. Baruch students dominated the top 20 positions and this year took home the prize money for first and third place finishes.
Baruch College students Linying Wu (left) and Kun Mao (right) received their checks in class from Phil Roth, CMT and Bruce Kamich, CMT of the foundation.

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**Letter from the New Editor of the Journal of Technical Analysis**

*by Julie Dahlquist, Ph.D., CMT*

**Editor’s Note**: Julie Dahlquist, Ph.D., CMT, was recently named as the Editor of the MTA’s premier research publication. She provided the following comments:

I am excited to serve as the new Editor of the *Journal of Technical Analysis*. Since it was first published as the *MTA Journal* in 1978, the *Journal* has been the premier outlet for research relevant to the theory, practice, and application of technical analysis. Many talented individuals have contributed to the success of the *Journal*, including the former editors, committee members, paper reviewers, and paper authors. Building on the work of these dedicated people, I am eager to use my writing, publishing, and research experience to enhance the value of the *Journal* to the members of the MTA.

As the new Editor I am personally committed to the production of a journal that provides valuable information to the MTA membership through articles that are of interest and use to practitioners. It is my desire that the *Journal* also enhance interest in technical analysis by providing non-MTA readers with material to expand their knowledge of the discipline.

This spring, I served on a steering committee with Michael J. Moody, CMT, and George A Schade, Jr., CMT that was tasked with formulating a vision and plan for the *Journal* to ensure that it best supports the goals of the MTA while serving the needs of the MTA membership. We proposed the following mission statement which was adopted by the MTA Board:

The mission of the *Journal of Technical Analysis (JTA)* is to advance the knowledge and understanding of the practice of technical analysis through the publication of well-crafted, high-quality papers in all areas of technical analysis. Features of the Journal include:

- Research articles accessible by and of special interest to practitioners.
- Survey and synthesis articles intended to provide the reader with an understanding of the current state of practice in a particular area.
- Clinical/case studies of high interest and benefit to the profession.
- Tutorials of interest to both academics and practitioners.
- Practitioner surveys.
- Reviews of business/finance books of interest to practitioners.

Sponsored by the MTA, the JTA is designed to meet the needs of the JTA’s largely practitioner readership. Thus, articles published in the JTA must be of interest to or use to practitioners of technical analysis. In addition, articles must be written in a style that is accessible to the MTA and the JTA readership.
the general MTA membership. The JTA editor assures that the topics published in the Journal generally reflect the professional interests of the global membership of the Market Technicians Association.

Articles published in the JTA must demonstrate accurate and well-executed research. The JTA maintains high standards for article quality, using a double-blind peer review system. This double-blind review system, in which the identities of authors are not revealed to the reviewers and the identities of reviewers are not revealed to authors, is designed to produce objective and unbiased peer reviews.

Of course, publishing a high-quality journal will continue to require the work and contributions of many people. In order to provide a double-blind review process, a large base of potential reviewers must be maintained. To have the most qualified reviewers for particular papers, we will need specialists in all areas of technical analysis. If you would be interested in serving as a reviewer, please let me know. As potential manuscripts are submitted for consideration, they will be sent out to experts in the subject area for anonymous review. As a reviewer, you would be asked to provide recommendations regarding the appropriateness of the manuscript for inclusion in the Journal within the next three weeks. If you find that the topic is not one you are comfortable commenting on or if other obligations prevent you from providing timely feedback, you will have the option of passing on particular reviews. Depending upon the number of papers submitted in a particular subject area, reviewers will generally be asked to review only two or three papers a year.

Most importantly, the quality of a journal depends on the quality of submitted manuscripts. I encourage you to consider how you might share your knowledge and understanding of the practice of technical analysis by writing an article for the Journal. I would be happy to discuss any ideas you might have and how these might be developed into an article for the Journal of Technical Analysis. You can reach me at journal@mta.org.

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**Interview with Ken Winans, CMT**

*by Amber Hestla*

**How would you describe your job?**

I am President and Founder of Winans International Investment Management & Research. My job involves overseeing the functions of running an investment firm (marketing the firm's services, investment management, investment research, client servicing, and business operations). Yes, I still find time to do my own research. Go to www.winansintfl.com for more details.

**What led you to look at the particular markets you specialize in instead of another tradable?**

After the 1987 Crash, I realized that brokers and investment advisors who had books of business (i.e., clients) in core assets (stocks, bonds, REITs, etc.) were not the people losing their jobs on Wall Street. My plan was to focus my research and asset raising efforts in mid to large cap stocks and high to mid-grade corporate bonds. This plan worked well in that I succeeded in making Merrill Lynch’s “Executive Club” for new client development during my rookie year in 1991. Simply put, the investments I selected had broad appeal to most investors and my technical/fundamental style allowed me to differentiate myself from competitors.

**Do you look at fundamental or economic inputs to develop your opinions?**

I primarily rely on my own research for market analysis and investment selection.

My market analysis is a classic technical approach with a filtered 200-day moving average as the "keel to my ship". This determines how much cash is held within our portfolios at any given period in time. As a market historian, my technical tools have been reviewed through all market conditions since 1900 in order to gain a broader understanding of how these various technical tools worked in the past.

Investment selection starts with a fundamental review of what to buy. In fact, the quality of the individual investments in our portfolios is rarely questioned. When to buy, take profits and reduce loses is mostly determined by our technical research.

**Can you share any longer term market opinions?**

Regardless of any short-term market advance, I expect the foreseeable future will resemble the economic challenges of the 1970’s. During that time, major stock market averages traded within a well-defined range and other investment types (bonds, preferreds, REITs, etc.) offered comparable returns to common stocks.

There are several key things to watch in 2011:

- **Municipal Bonds** – The fear of large municipalities filing for bankruptcy nationwide will continue to cause high levels of price volatility in municipal bonds. History shows us that during the widespread municipal defaults of the 1931-33, municipal bond yields increased 48%.
- **Housing** – Real estate’s falling prices continue to be the elephant in the room in relation to the overall strength of this economic recovery. History tells us that there will not be a long running bull market in stocks until real estate prices have stabilized.
- **Global Inflation** – The fear of the government’s monetary stimulus programs creating conditions for future inflation should cause higher price volatility for bonds with maturities exceeding 15 years. Investors should continue to limit fixed-income investments to 10 years and under.

WI's investment strategy continues to be:
● Common Stocks: WHEN to buy and sell is as important as WHAT to buy and sell during these types of market conditions. I believe profitable navigation of these market conditions is possible by using higher levels of investment rotation, a willingness to hold high levels of cash after significant market advances and/or strategically using some hedging during volatile downturns.
● Corporate Bonds: Short to medium term bonds in stable companies are currently yielding 5% - 7% annually. Cautious investors should consider investing a higher portion of their portfolios in the more predictable returns generated by corporate bonds rather than the ongoing volatility of a sideways moving stock market.
● Preferred Stocks: We expect preferred stocks to maintain attractive yields, and can be a good addition for up to a 25% allocation in an income portfolio.

What advice would you have for someone starting in the business today?

Future opportunities lie in asset management for those CMTs who have developed a specialized area of expertise. There is still uncharted territory to research in real estate and fixed income.

Kenneth G. Winans, CMT, MBA, is a veteran investment manager and an author of three books about investing. He developed and manages two economic indicators, covering preferred shares and housing. And he is a regular contributor to Forbes and a frequent commentator on investing and the economy.

For over 29 years, he has conducted landmark investment research and designed creative investment strategies while serving as a portfolio manager, investment analyst, broker and investor.

He is a regular guest on TV and radio shows nationwide and has had much of his investment research published as headline articles by leading websites, magazines and newspapers. As one of today's top technical analyst, Ken co-hosts San Francisco's newest radio talk show “The Best of Investing” (KNEW-980am). He is also a senior market commentator on one of Los Angeles' most popular business news radio stations (CBS affiliate KNX-1070 AM). is a successful investment management entrepreneur, an award-winning author, and an active philanthropist.

These questions and answers have been compiled by Amber Hestla, an independent market researcher. If you'd like to participate in a future interview, please contact her at hestlaresearch@gmail.com.

Relative Strength on Long-Term Charts

By Mike Carr, CMT

One of the most widely used tools in technical analysis is relative strength. The idea behind this technique is to identify individual stocks which are outperforming the general market. Numerous academic studies have shown that a portfolio comprised of stocks which have been market leaders for the past 3-12 months will usually outperform the market averages over the next 3-12 months. There are a number of ways to calculate relative strength, and practitioners apply the idea in a number of different ways.

Broad index analysis is another tool that technicians use to identify long-term trends in the stock market. To do this, a ratio of two indexes is charted, in effect creating a relative strength chart between the two indexes.

Louise Yamada, CMT, presents a detailed explanation of this idea in her 1998 book, “Market Magic.” She shows how the Capital/Consumer ratio could be used to help identify major stock market turning points. Her research shows that shifts in leadership occur every 4-10 years and are accompanied by market declines. To present this idea, she uses long-term, monthly charts.

Other analysts have offered the idea that investor preferences shift towards defensive stocks in bear markets. Several sector rotation models have been developed to explain how investors shift from being aggressive to defensive as markets rise and fall. In a broad sense, this can be displayed as the ratio of growth to value stocks. Value stocks would be considered safer investments, and we'd expect to see investors shift their portfolios to favor safer stocks in a decline. As markets rise, investors would become more aggressive and shift to growth stocks.

In the chart below, we can see the growth-value ratio plotted under the price of the S&P 500 Citigroup Pure Growth Index. As expected, value stocks, represented by the S&P 500 Citigroup Pure Value Index, performed better than growth stocks in the bear market, and growth was the leader in the bull market. It may be surprising to note that the ratio reversed course right at the bottom. Many technicians apply contrary analysis, believing the majority of investors will be wrong at key turning points, but this chart does not offer support to that theory.
In the next chart, we look at an individual stock, Johnson & Johnson (JNJ). This is an example of a defensive stock, one offering a steady dividend and delivering medical supplies which should be virtually recession proof. Relative strength is shown in the chart as the solid purple line below price, and is the lowest line on the far right side of the chart. This line indicates whether the stock price is outperforming, lagging or keeping pace with the general market as represented by the S&P 500 Composite Index. We would expect defensive charts to perform well in recessions, which are marked as dark grey vertical areas in the chart. The chart shows that the relative strength line of JNJ is rising in each recession, offering some proof that defensive stocks outperform in those times.
Looking closer at the chart, we can see that the relative strength of JNJ actually starts increasing before the onset of the recession. The only exception is the brief 1980 recession. This would indicate that investors do anticipate the bad economic times and take defensive actions in their portfolio.

Relative strength can be used to manage portfolios in the short-term. This technical tool also offers a way to test theories by reviewing the long-term. In this case, we can see that defensive stocks such as JNJ are likely to outperform in recessions.

This article originally appeared at http://www.srcstockcharts.com/blog/ and is republished with the permission of SRC.
Please join me in congratulating Tim on his promotion and wishing him continuing success in the future.