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Investment Brokerage

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SHOULD I BUY, SELL OR HOLD?

"If the market goes up when investors are in a good mood, why don't you guys put all of your clients on Prozac?"

Leigh Baldwin & Co. Investment Brokerage Newsletter

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Should I Buy, Sell or Hold?

Don't gamble! Take all savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it.—

Will Rogers

"How is the stock market doing?" "Should I be buying or selling?" "What are stock market trends, and how can they help me to create greater returns?"

If you have asked yourself any of these questions, then this article will help you to understand the subject of market trends and why it is an important aspect of investing. This knowledge may help you to maximize your profits as well as to minimize your losses.

THE DOW THEORY

The Dow Theory is the grandfather of all technical stock market studies and is regarded as the comprehensive principle of stock market behavior. It was designed to gauge the action of the stock market itself, deriving nothing from basic business fundamentals. Charles H. Dow, founder of the Dow-Jones financial news service, is credited with the invention of stock market averages. He did not look upon his theory as a device for forecasting the market, or even as a road map for investors, but rather as a barometer of general business trends.

The basic principles of the Dow Theory include:

The discounting affect

The combined market activities of thousands of investors determine the Dow Averages. These averages immediately discount every foreseeable condition (i.e. profits, losses, labor disputes, new products, pending government legislation, etc.) which can affect the supply or demand for stocks before it actually occurs. Unpredictable happenings, including natural and human disasters, are appraised soon after they happen.

The three trends

The Dow Theory identifies stock market activity conforming to three trends. The primary (major) trend, secondary (intermediate) trend, and day-to-day (minor) trend. These trends may be either up or down (bull or bear).

☒ The primary trend—ocean

The primary trend is often referred to as the ocean tide. Its broad movements usually last for more than one year and may run for several years. The result is a general appreciation or depreciation in value of more than 20%. Stocks alternatively move from periods of undervaluation, depression and low volume to periods of overvaluation, optimism and high volume. Investing contrary to the primary trend is highly risky.

According to the theory, the long-term investor is only concerned with the primary trend. His or her aim is to buy stocks as early as possible in an up (bull) market and hold them until it becomes evident that a down (bear) market has started.

☒ The secondary trend—wave

The secondary or intermediate trend is symbolized by the wave, and it lasts from a few weeks to a few months. The wave normally retraces (pulls back) from one-third to two-thirds of the gain or loss registered by the preceding swing in the primary trend.

While the long-term investor is only concerned with the primary trend, the nimble trader may certainly find profit opportunities within the secondary or intermediate trend.

☒ The minor trends—ripples

Minor trends, or ripples, usually last

less than six days but have been known to last as long as several weeks. These are the day-to-day movements of the averages and are considered unimportant to the Dow Theorist. Also ignored by the Dow Theorist are any extreme highs or lows which are reversed during a given trading day. Only closing prices merit recognition.

The bull market

The bull market reflects an improving outlook for corporate profits. It occurs when each successive rally of the intermediate trend reaches a higher level than the one before and each secondary reaction achieves a higher level than the previous reaction.

At the onset of the bull market, accumulation takes place. Business conditions are still poor, and the public is generally discouraged with the stock market. Stock values begin to rise from depressed levels, but can still be purchased at bargain prices. The second phase of the upward primary trend is characterized by a fairly steady advance on increasing activity. Business conditions and corporate earnings are improving. This is usually the longest, most deceptive phase since shocks to business along the way may result in secondary bearish trends. The final phase is distinguished by highly publicized good news. Price gains are spectacular, and the public becomes heavily invested. The bull market tends to end amid euphoria and excessive optimism about the future.

The bear market

The bear market is the result of previous bull market excesses. This market reflects deteriorating business conditions which have a negative effect on corporate profits. It occurs when each intermediate decline carries prices to successively lower levels, and each intervening rally fails to exceed the top of the previous rally. The primary trend of the bear market is down, and most common stocks decline. Unfortunately, neither the extent nor duration of a bear market can be predicated.

The first phase of the bear market, known as distribution, occurs when far-sighted investors sell their shares to the less-informed investors. The trend's second phase is panic.

Buying decreases, selling becomes more urgent, and the downward trend of prices accelerates on increasing volume. The third phase is comprised of a long secondary recovery or a sideways movement. Eventually, the business news begins to deteriorate, and prices resume their decline, though less rapidly than before. The public sells its shares which were accumulated earlier at higher prices. The bear market ends when the worst can be foreseen, and the market has discounted all possible bad news.

Principle of confirmation

Dow theorists rely heavily on the principle of confirmation to validate a change in a stock market trend. No legitimate signal of a change in trend can take place by either the Dow Jones Industrial Average or the Transports Average independently of the other. If one average achieves a new high over its previous peak, but the other average does not, a non-confirmation occurs. The move must be considered suspect until both averages confirm by exceeding their prior highs.

Trading volume

Although conclusive signals as to the market's trend are produced by price movement, volume may also play a role. The trading volume provides theorists with additional evidence which may aid in interpretation of an otherwise doubtful situation. In bull markets, volume generally tends to increase on rallies and decrease on declines. In bear markets, the reverse is usually true.

Reversals

The Dow Theory's final principle dictates that a trend continues until it is reversed. Once a new primary trend is unquestionably signaled by the action of the two averages, the odds are that it will continue. However, as the primary trend endures, the odds in favor of its further extension diminish.

The principle of reversal is a basic test of probability. It is a warning against changing one's market position too soon. It expresses the idea that the odds are in favor of the investor who waits until he or she is sure of a reversal and against the investor who buys (or sells) too early.

What Is technical stock analysis?

Technical analysis is useful to everyone—not just to the short-term trader or intermediate speculator, but to the long-term investor as well. The purpose of this short course is to introduce you to some basis chart analysis techniques.

Neither fundamental analysis nor technical analysis can claim absolute precision because they are only barometers to help forecast the future price of a security. There are two values of a security—the actual value, which is estimated, and the market price, which is known.

The actual value of a company is the price which it would theoretically be worth if someone were to actually buy it. Fundamental analysis tries to determine the actual value of the company. This value is useful because it acts as a magnet to the market price, pulling it back from extremes of overvalue or undervalue. But actual value is not an absolute since it, too, is subject to market pressures of supply and demand. This is true even if its fundamental characteristics remain stable.

The problem is that we do not buy the assets of the company. We buy the stock at the market price, which in the action market is affected by crowd psychology and the alternating emotions of confidence and fear. In the extreme, the market is affected by greed and panic. The overall trend of money flowing in or out of the market is what affects the market price of your stock. Charts can reveal at a glance the influence of market psychology on the flow of money into or out of the stock. Actual value is only an estimate, and market psychology creates stock movement above and below the actual value.

As a practical matter, how do we use this knowledge? If we estimate the actual value of a company to be \$75/share, and the market price is \$30/share, we can assume that the market price will eventually move back toward \$75/share. However, if the chart reveals that the price is still trending down, it

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is prudent to wait until the trend has clearly reversed itself before committing funds to the stock.

Conversely, if you owned the same $75/share stock (estimated actual value) that was selling for $115/share, you should assume that the price will eventually decline to $75/share. However, you can continue to hold the stock as long as a steady up trend is maintained. It could literally be years before the trend changes.

A short course

The purpose of this short course is to give you a basic understanding of technical analysis. All stocks are in one of four major stages, and the trick is to be able to identify each stage level. The four stages of a major cycle, as illustrated in the following chart, are:

Stage I. The basing area

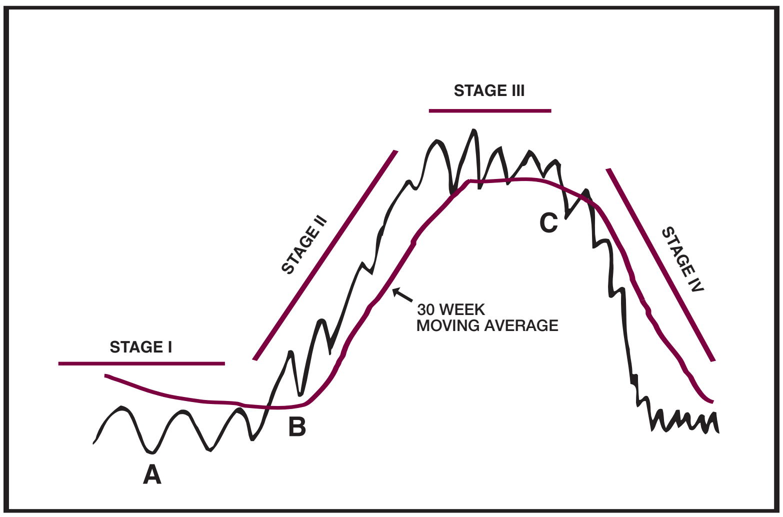
Stage II. The advancing stage

Stage III. The top area

Stage IV. The declining stage

Stage II:
The "perfect" time to buy is when a stock is finally advancing from its base at (point B). A breakout across the top of the base (point B) should happen with impressive volume. Now the uptrend is beginning. The Moving Average usually starts turning up shortly thereafter, and the pattern becomes a buyer's dream. (A 30 week moving average is a charting calculation used by security analysts to plot a weekly stock price close for the previous 30 weeks.)

At this point the pattern reveals that the stock is making higher highs and higher lows. All of these minor corrections develop above the stock's moving average, which is dramatically trending higher. In some instances, this powerful trend can last a long time, creating huge profits. Follow this trend carefully; when the stock starts to dip closer to its Moving Average and the M.A. starts to round over, that is the start of Stage III.



Stage I:
As emotional sellers battle with potential buyers, there is a series of swings between support (buyers) and resistance (sellers). A base is being formed, but it can go on for months, or in some instances, for years. Even if you bought at the exact low (point A), this would be a mistake. Your money could be dormant for a long time thereafter with little movement. The best strategy is to observe the base-building process closely since these stocks will eventually break out to form the next and most dynamic cycle, which is Stage II.

Stage III:
Instead of continued upside progress, there is significant churning between buyers and sellers. At this stage, the stock begins to penetrate its Moving Average. Once you identify a stock developing a Stage III pattern, you should sell your position or, at the least, protect your capital with a close sell stop order. (*A sell stop order is an order to sell at the market price once the security has traded at a specified price.*) A stop order to sell must always be executed when the sell price is at or below the stop price.

Good news (earnings, new products, etc.) is typical of a Stage III stock. Start selling, and never buy a stock in this part of the cycle, regardless of the news. Once the stock breaks the Moving Average (on increased volume), it enters Stage IV.

Stage IV:
There is absolutely no excuse for continuing to own a stock once it has entered this stage. Each rally peak fails to better the previous one and each new low is lower than the one before. At the same time, the Moving Average is relentlessly moving lower. Unfortunately, this is the stage in which novice investors attempt to grab a bargain because they think the stock has already fallen enough. **Big mistake!**

If we were to define the most fundamental approach to the stock market, it would be to reduce risk as much as possible. One vital aid in reducing the normal market risk of buying any stock is to actually wait for "the breakout." To be a successful investor, wait patiently until a desirable stock is passing from Stage I (the basing area) into Stage II (the Advancing stage). It is always better to buy an advancing stock ("the trend is your friend") as opposed to trying to pick a bottom in a declining Stage IV stock.

Putting it all together

Unfortunately, there is no magic bell that rings to signal the beginning or end of a trend. However, we have outlined a few signs to look for along the investment trail. Knowing the current market environment is critical in one's attempt to maximize profits and minimize losses. ■