CHAPTER 1

How to Buy

Successful trading requires confidence; but, paradoxically, it also demands humility. You must realize that the markets are huge and there is no way you can master everything there is to know about them. Your knowledge of the markets can never be complete.

You need to specialize in a certain area of research and trading. You can compare financial markets to medicine; a modern physician cannot be an expert in surgery, ophthalmology, psychiatry, obstetrics, and pediatrics. Such universal knowledge may have been possible centuries ago, but the modern field of medicine has become so huge that all physicians must specialize. They must choose one or perhaps two areas and master them. Outside of those areas they need to know just enough to avoid trouble.

THE THREE GREAT DIVIDES

A serious trader needs to specialize just like a serious physician. He must choose an area of research and trading that appeals to him. Here are some of the key choices every trader needs to make:

- **Technical vs. Fundamental**
  Fundamental analysts study the values of listed companies or the supply-demand equations for commodities. Technicians, by contrast, believe that the sum total of knowledge about any market is reflected in its price. Technicians study chart patterns and indicators to determine whether bulls or bears are likely to win the current round of the trading game. Needless to say, there is a bit

of overlap between the two fields. Serious fundamentalists often look at charts, while serious technicians may have some idea about the fundamentals of the market they are trading.

- **Trend vs. Counter-Trend**
  Most charts show a mix of directional moves and choppy trading ranges. Beginners are fascinated by powerful trends: if they could buy at a bottom, so clearly visible in the middle of the chart, and hold through the ensuing rally, they'd make a lot of money in a hurry. Experienced traders know that the trends, so clearly visible in the middle of the chart, become increasingly foggy as you near the right edge. Riding a trend is like riding a wild horse that tries to shake you off at every turn. Trend trading is a lot harder than it seems. At the same time, one of the few scientifically proven facts about markets is that they oscillate. They continuously swing between being overvalued and undervalued. Counter-trend traders capitalize on this chop of the markets as they fade (trade against) the extremes.
- **Discretionary vs. Systematic**
  Applying your studies and indicators to a chart can be an exciting and engaging process. Discretionary traders keep turning their studies this way and that as they decide whether to buy, sell, or do nothing. Some traders enjoy this game, while others get stressed by this never-ending need for decision-making. System traders prefer to dump market data into a computer, test a set of rules for buying and selling, and then turn the system on and follow its signals.

Another key decision in the markets involves deciding whether to focus on stocks, futures, options, or forex. You may want to specialize even further, by choosing a specific stock group or one or two specific futures. Whatever your trading vehicle, it pays to define your work along the three axes: fundamental/technical, trend/counter-trend, and discretionary/systematic. Being clear about your likes and dislikes will help you avoid flopping around the markets, the way so many people do.

It is important to realize that in each of these great divides both sides are equally valuable. Your choice will depend primarily on your temperament. Professional traders tend to have an open mind. They are always curious about other people's opinions and are respectful towards them. Only arrogant greenhorns look down upon those who have made different choices.

TECHNICAL VS. FUNDAMENTAL ANALYSIS

A fundamental analyst spends his time calculating the value of the business that any given stock represents. He evaluates company earnings, competitive position, management, and other factors. Fundamental analysts of commodities study supply and demand for their markets. For example, when the country's orange-growing regions expect a severe frost, fundamental analysts know that the value of the surviving crop will increase and prices will follow. The big questions then become what portion of the crop is likely to be lost and what will happen to demand in response to a price increase.

A pure technician may not care about the earnings, the frost, or a heat wave. All he wants is the ticker or a symbol and a history of transactions going back some time. He expects to pull some repetitive pattern out of that history and trade it for profit.

Purity and other forms of extremism may attract beginners, but a more mature individual is not likely to see the markets in black and white. It is perfectly normal to feel more attracted either to fundamental or technical analysis. At the same time, an experienced trader, be he a fundamentalist or a technician, does not reject the other point of view but tries to look at the markets with both eyes.

Whether you feel inclined towards fundamental or technical analysis, you have to be curious about how the other side lives. The great Warren Buffett, probably the top fundamental analyst and money manager in the United States, says that people who do not look at prices are like card players who do not look at cards. My own heart is in technical analysis, but whenever I become interested in a stock I like to ask several fundamental questions. I definitely want to know to what industry it belongs. I'd much rather trade a stock in a growth industry, such as nanotechnology or telecommunications, than in some old sluggish group. Also, I tend to stay away from shorting energy stocks and futures, because of my concerns about Hubbert's Peak[1] which calls for a tightness of energy supplies in the coming years.

---

[1]Deffeyes, Kenneth S. *Hubbert's Peak: The Impending World Oil Shortage* (Princeton University Press, 2003)

Figure 1.1 The Difficulty with Fundamental Analysis

The fundamentalist's dilemma: this daily chart of IBM shows that while the value of the company is increasing, the uptrend is anything but steady. You can see violent moves in the direction of the trend as well as against it. Day after day, prices change, with the company valued 1% more or 1% less, in the absence of any meaningful news. Prices are attached to values with a mile-long rubber band, making a fundamentalist's lot a hard one!

The problem with fundamental analysis is that values change slowly but prices fluctuate all over the lot. One of my students summed up this problem when he said: "Prices are connected to values by a mile-long rubber band" (see Figure 1.1).

While fundamentalists search for value in the long rows and columns of their spreadsheets, a technician can quickly identify values in any market using a few simple tools. My favorite method for discovering value is to use an exponential moving average—two moving averages, to be exact.

Moving averages identify the levels at which most market participants agree on value (see Figure 1.2). A rising moving average shows that value is increasing, and a falling moving average tells us that value is decreasing.

A trade is an agreement between a buyer and a seller. Since they transact in the midst of the market crowd, their trade represents a mo-

Moving Averages

A single price does not tell you whether the crowd is bullish or bearish—just as a single photo does not tell you whether a person is an optimist or a pessimist. If, on the other hand, someone brings ten photos of a person to a lab and gets a composite picture, it will reveal that person's typical features. If you update a composite photo each day, you can monitor trends in that person's mood.

A moving average serves as a continuously updated composite photograph of the market—it combines prices for several days. The market consists of huge crowds, and a moving average identifies the direction of mass movement.

The most important message of a moving average is the direction of its slope. When it rises, it shows that the crowd is becoming more optimistic—bullish. When it falls, it shows that the crowd is becoming more pessimistic—bearish.

From *Trading for a Living* by Dr. Alexander Elder,
John Wiley & Sons, Inc.,1993

mentary consensus not just between the two persons but for the crowd as a whole. If every tick on your screen represents a momentary consensus of value, then a moving average represents a composite photograph, a longer-term consensus.

A faster moving average represents a short-term consensus. A slow moving average represents a longer-term consensus. I call the area between the two lines "the value zone."

Using moving averages to identify value helps differentiate between two different types of trading. A trend-following trader wants to buy when prices pull back towards a rising moving average. A counter-trend trader recognizes when the prices get too far away from the value zone, and gets ready to trade the snap-back.

TREND VS. COUNTER-TREND TRADING

Take a look at the chart in Figure 1.2, and the arguments for and against trend or counter-trend trading will leap at you from the page. You can easily recognize an uptrend: when prices run from the lower left corner to the upper right corner, you do not need to be a technician

Figure 1.2 Moving Averages Identify Value
Daily chart of MW, 26-day and 13-day EMAs

A. Pullback to value in an uptrend—Buy!
B. Price far above value—Sell!
C. Price far below value—Buy!

The slow EMA (exponential moving average) rarely changes direction; its angle identifies the increase or the decrease of value. The faster EMA is more volatile. When prices dip into the zone between the two lines during an uptrend, they identify good buying opportunities. Prices are attached to values with a rubber band; you can see that prices almost always get only so far away from the EMA before they snap back. When a rubber band extends to the max, it warns you to expect a reversal of the latest move away from value.

to identify a bull market. It seems simple enough to buy and hold—until you realize that this trend, just like any other, is clear only in retrospect. If you had a long position, you'd be wondering every day, if not every hour, whether the uptrend was at an end. Trying to ride a trend is like trying to ride a high-strung horse that keeps trying to shake you off and at times rolls on the ground to get rid of you. Sitting tight requires a great deal of mental work!

Counter-trend trading has its own pluses and minuses. You can see how prices keep outrunning themselves time after time. They keep getting away from value, only to snap back to it. Buying below value and shorting when prices rise too far above value has a different attraction:

the trades tend to last only a few days. They require less patience and make you feel much more in control. On the minus side, the profit potential of each trade is smaller.

This is the choice you need to make: you can trade in the direction of a long-term moving average or you can bet on prices returning to their moving average after they become overextended. The first approach is called trend-following; the second, counter-trend trading.

In his brilliant book *Mechanical Trading Systems: Pairing Trader Psychology with Technical Analysis*, Richard Weissman draws a clear distinction between three types of traders: trend-followers, mean-reversal (counter-trend) traders, and day-traders. They have different temperaments, exploit different opportunities, and face different challenges.

Most of us fall into one of these trading styles without giving it much thought. Very few of us make a conscious business decision. For example, when I began to trade, many serious and intelligent people told me I had to be a trend-follower. I did it for many years, but my heart was not in it. After years of trying to be a trend trader, I came to realize that what I really wanted to do was counter-trend trading. I have been happier and much more profitable ever since. Many of my friends, on the other hand, only trade trends and would not touch a counter-trend trade. You have to figure out who you are, and trade accordingly.

DISCRETIONARY VS. SYSTEMATIC TRADING

This is another great divide in trading, and you need to know very clearly on which side of it you stand. Both are perfectly acceptable, but there is an abyss between them. You can bridge it, but please do not try to jump across while you are in a trade.

A discretionary trader looks at a chart, reads its signals, and places an order to buy or sell short. He monitors the chart and at some point realizes that the signals that prompted him to go long or short have disappeared or reversed. He decides to place an order to exit and completes his discretionary trade.

A systematic trader cannot tolerate this degree of uncertainty. He does not want to keep making decisions every step of the way. His solution is to study historical data, design a system that would have performed well in the past, fine-tune it, and turn it on. From now on he lets his system track the market and generate buy and sell signals.

Neither discretionary trading nor system trading will guarantee success. Beginners lose money with both, but in different ways. When a beginning discretionary trader shows me certain signals on his charts, he is likely to overlook other, just as strong or even more powerful signals that point in the opposite direction. A beginning systematic trader is very likely to fall into the sin of curve-fitting. He spends time polishing his backward-looking telescope until he has a system that would have worked perfectly in the past—if only the past repeated itself perfectly in the future, which it almost never does.

I am attracted to discretionary trading because of its freedom. I find it extremely attractive to approach the market like a blank slate, study broad indexes and industry groups, and decide whether to trade from the long or short side. It is a pleasure to establish entry and exit parameters, apply money management rules, determine the size of a trade, and finally place my order. There is a sense of responsibility and thrill in monitoring the trade and deciding to exit as planned, jump a little sooner, or hold a little longer. I am also attracted to counter-trend trading, but most methods described in this book can also be used by trend-followers.

Systematic traders try to capitalize on repeating patterns in the markets. The good ones know that while things repeat, they do not repeat perfectly. The most valuable quality of a good system is its robustness. A system is called robust when it continues to perform reasonably well even when market conditions change. There is a body of literature on system development, and a good starting point is Robert Pardo's *Design, Testing and Optimization of Trading Systems.* Shortly after writing it, Bob became a noted money manager by implementing his methods in the real world. Not too many authors can make that claim.

The decision to be a discretionary or a systematic trader is rarely based on cost-benefit analysis. Most of us decide on the basis of how we feel about choices in life in general. When I interviewed Fred Schutzman for my book *Entries & Exits,* he said:

> System trading works for us because it takes the emotion out of trading. I am not good at making live decisions. I am more of a researcher, a scientist. I can talk to the computer and it can do the trading for me. . . . if we can program concepts, I can continue as an analyst and the computer will trade unemotionally. I am doing

> the analysis, and the computer trades off my inputs. It pulls the trigger if the conditions exist. . . . System trading is not for everyone—a lot of people do not like handing the power over to a computer. They want to retain responsibility for the decisions.

Paradoxically, at the top end of the performance scale there is a surprisingly high degree of convergence between discretionary and systematic trading. A top-notch systematic trader has to keep making what looks to me like discretionary decisions: when to activate System A, when to pull back System B for underperformance, when to add a new market to the list of those he trades, or when to drop a market from the list. At the same time, a discretionary trader like me has a number of firm rules that feel very systematic. For example, I will absolutely not enter a trade against the weekly Impulse system, described below, and you couldn't pay me to buy above the upper channel line or short below the lower channel line on the daily charts. The systematic and the discretionary approaches can be bridged—just do not try to do it in the middle of an open trade. Do not change your horses in the middle of the stream you're trying to cross.

ONE TRADER'S TOOLBOX[2]

When I put on my first trade ever, the worst possible thing happened. I made money. That lucky break created the delusion that trading was easy. I began jumping into other trades—with a predictable outcome.[3]

As I recovered and rebuilt my devastated account I knew I had to educate myself. I began to read voraciously about the markets. I looked up sources and references in every book I read, and then read those books as well. In those faraway, pre-Internet days I was fortunate to find a gentleman in Los Angeles by the name of Donald Mack who ran a business called The Investment Centre Bookstore. I must have become

---

[2]This section presents a brief version. For full details, please see *Come into My Trading Room*, John Wiley & Sons, Inc., 2002.

[3]I recently volunteered to teach a course "Money and Trading" in a local high school. One of the best things to happen in that class was that we lost a few dollars on our first trade. The kids got upset, but it made everyone more alert and served as a good start for the year.

his biggest customer. My fantasy was that if I read everything there was to read and learn about every method, I'd surely find a good money-maker.

Once again, the outcome was predictable, and it was back to my day job, working and saving to rebuild my tiny account. Even though I lost money, all that reading left me with something positive—a good overview of the field.

Over the years, as I continued to trade and study the markets, it became increasingly clear to me that in this field "less is more."

Whenever we look at a chart, we deal with only five pieces of data—each bar has an open, high, low, and closing prices, plus volume. If you trade futures, add open interest. It makes no sense to use a long list of tools and indicators to analyze these five numbers. An abundance of tools only increases the level of noise and adds to the confusion. I established a rule of "five bullets to a clip"—allowing me to use no more than five indicators on any given chart. You may use six if you desperately need an extra one, but never more than that. For myself, I do well with four: moving averages, envelopes, MACD, and Force Index.

This does not mean that you should use the same indicators. You should feel perfectly comfortable using others—just be sure to understand how your indicators are constructed, what they measure, and what signals they give. No one can master everything in the markets, just as no physician can master all of medicine. You need to choose a small handful of tools that feel comfortable to you.

Market newcomers often become fascinated by technical trading tools. They imagine that if they get the "right" software, the "right" indicators, and the "right" settings the profits will just roll in. Nothing could be further from the truth! While technical tools are important, they are responsible for only a small share of any trader's success. You also need to focus on trading psychology, money management, and record-keeping. Each of those factors is like a leg of a chair, and technical analysis is just one of them. A chair that has only one leg is useful only for firewood.

Beginners' childish faith in the power of technical analysis is often coupled with a great deal of laziness. Each week I receive e-mails from people who ask for "the exact settings" of moving averages, MACD, and other indicators. Some say that they want to save time by taking my numbers and skipping on research so that they could get right on to trading. Save the time on research, my elbow! If you do not do your

My Toolbox

My approach is based on the Triple Screen trading system which I developed in the 1980s and continue to improve to this day. Since every market can be analyzed in several timeframes, Triple Screen insists that you begin by defining your favorite timeframe in which you like to work, such as daily, hourly, or weekly chart. Once you know what your favorite is, do not look at it! You must first go to the timeframe one order of magnitude higher, make your strategic decision there, and return to your favorite timeframe only to make a tactical decision—where to buy or sell—and then trade only in the direction of the longer timeframe.

Since my favorite timeframe tends to be the daily, I use weekly charts to make my strategic decisions, and return to dailies to implement them. The weekly and daily charts are my first two screens. The third screen is the entry method, for which you can either use an intraday chart or simply place an order using a daily chart.

Moving Averages

Price is a consensus of value at the moment of a trade. A moving average (MA) reflects an average consensus of value in its time window. If price is a snapshot, a moving average is a composite photograph. It provides two important messages to traders. First, its slope identifies the direction of change in the public's mood. A rising moving average reflects growing optimism (bullish), while a falling MA reflects growing pessimism (bearish).

Another important role of the MA is differentiating between what I call "value trades" and "greater fool theory" trades. If you buy near the moving average, you're buying value. A person who buys well above the moving average is in effect saying—"I'm a fool, I'm overpaying, but I hope to meet a greater fool down the road." There are very few fools in the financial markets, and a person who keeps buying above value is not likely to win in the long run. He may get lucky once in a while, but buying near value is a much more sensible strategy. I like using two EMAs on my charts, one showing a longer-term, and another a shorter-term, consensus of value. I call the area between them "the value zone." There are several types of moving averages, but I always use exponential ones. EMAs are more sensitive to incoming prices and less sensitive to old prices.

Envelopes or Channels

One of the very few scientifically proven facts about the markets is that prices oscillate above and below value. You could say that markets are manic-depressive—rising too high and falling too low, only to swing back to the normalcy of the value zone.

There are several types of channels, and my favorite is a straight envelope—the lines above and below the EMA, both parallel to it. A well-drawn channel fits like a good shirt, covering the body of prices, with only the most extreme prices—the neck and the wrists—sticking out. Amateurs love to buy breakouts, but professionals tend to look for buying opportunities near the lower channel line and shorting opportunities near the upper channel line.

Some traders like to use standard deviation channels, often called Bollinger Bands, which expand and contract in response to market volatility. They are only useful for options traders because volatility is a key factor in option pricing. If you trade stocks, futures, or forex, you are better off with straight envelopes.

MACD Lines and MACD-Histogram

Moving Average Convergence-Divergence (MACD) is an indicator whose fast line represents the short-term consensus of value, and the slow line the long-term consensus. When the fast line rises above the slow line, it shows that bulls are dominant, and when the fast line is below the slow line, the bears are in charge.

MACD-Histogram measures the power of bulls and bears by tracking the difference between the two MACD lines. When their spread increases, it shows that the dominant market group is becoming stronger—it is a good time to trade in that direction. Divergences between peaks and bottoms of MACD-Histogram and price are among the strongest signals in technical analysis.

MACD-Lines and MACD-Histogram are derived from three exponential moving averages of closing prices. Their settings—12, 26, and 9—have migrated into trading software and become default settings in many packages. In writing my books, I used those settings to illustrate this indicator.

What settings should you use? If you want to use the same ones as everyone else, use 12, 26, and 9 because the crowd is basically lazy and uses the default values. You can also choose settings that are a little faster or a little slower. Think about it and experiment with the values, or use the defaults.

Force Index

Everybody watches prices, but it is volume that moves them. Volume reflects the intensity of traders' commitment, the heat of their exuberance, the depth of their fear. Instead of looking at a plain plot of volume, I use

Force Index, which links volume with price changes. Divergences between Force Index and prices tell me when a trend is becoming weak and ready to reverse. By contrast, new highs of Force Index tell me that the trend is strong and likely to continue.

The Impulse System

This system identifies bullish and bearish phases in any market or timeframe by combining two indicators. The slope of the fast moving average identifies the inertia of the market, while the slope of MACD-Histogram identifies the push of the bulls or bears. The Impulse system gives a buy signal when both the EMA and MACD-Histogram rise, and a sell signal when both decline. When the two indicators get in gear, they mark especially bullish or bearish periods. Just as importantly, the Impulse shows when bulls or bears start slipping, and a trend starts growing weaker.

One of my Traders' Camps graduates, a brilliant programmer named John Bruns, programmed the Impulse system for several popular software packages, coloring each bar in accordance with the Impulse system. When the EMA and MACD-Histogram rise at the same time, the market is in gear to the upside and the bar turns green. When both fall, bears are in control and the bar is red. When the two indicators point in opposite directions the bar is blue.

The Impulse system	The slope of EMA	The slope of MACD-Histogram	The trading message
Green	Up	Up	Long or stand aside; no shorting
Red	Down	Down	Short or stand aside; no buying
Blue	Up	Down	Either long or short
Blue	Down	Up	Either long or short

The Impulse system works best as a censorship method. When the Impulse is green, you may buy or stand aside but absolutely no shorting is permitted. When the Impulse is red, you may go short or stand aside but buying is prohibited. I wait for the Impulse system to go "off green" before shorting and "off red" before buying.

Some programs do not allow users to change the color of their bars on the basis of conditional formatting, but you can still identify green or red Impulse by noticing the slope of the EMA and MACD-Histogram.

Adapted from *Entries & Exits* by Dr. Alexander Elder,
John Wiley & Sons, Inc., 2006

own research, you will not have the necessary confidence during the inevitable drawdown periods.

I believe that successful trading is based on three M's—Mind, Method, and Money. Your Method—the indicators and tools—is just one component of this equation. Equally important is the Mind—your trading psychology—and the Money, or risk control. Record-keeping ties all of these three M's together into a firm, working structure.

In a moment we will talk about the Mind, the Money, and the Record-Keeping. But before we move on, let us stay a little longer with the trading tools and review what I think is the best leading indicator of the stock market—the New High–New Low Index.

THE NEW HIGH—NEW LOW INDEX

Most traders pay attention to the key market indexes that are given to them ready-made, such as the Dow, the Nasdaq, and the S&P. There is one additional market indicator that is much more forward-looking. I believe that the New High–New Low Index (NH-NL) is the best leading indicator of the stock market. I look at it every day to confirm my bullish or bearish stance. NH-NL takes a bit more work to construct, although its formula is very simple.

NH-NL = (New Highs) minus (New Lows)

NH-NL is very easy to track by hand, since the raw data is published daily in all major newspapers. For example, yesterday there were 51 new highs in the market and 98 new lows, giving us NH-NL of minus 47. The day earlier we saw 43 new highs and 130 new lows, resulting in NH-NL of minus 87. Plotting these numbers on a day-to-day basis gives us three lines: New Highs, which I like to plot in green, New Lows, which I plot in red, and daily NH-NL which I plot in some neutral color.

Plotting the weekly NH-NL is a bit more tricky, as you have to decide when your week ends. I used to plot this indicator by adding daily numbers for the past week, but last year switched to plotting weekly NH-NL as a 5-day running total of daily NH-NL.[4] For example, as I write this on a Wednesday morning, my weekly NH-NL for the past night

[4]This change reminds me of a sentence with which I ended my first book: "I continue to learn, and like any trader, I reserve the right to be smarter tomorrow than I am today."

New High–New Low Index

A stock appears on the list of new highs when it is the strongest it has been in a year. This shows that a herd of eager bulls is chasing its shares. A stock appears on the list of new lows when it is the weakest it has been in a year. It shows that a crowd of aggressive bears is dumping its shares.

The New High–New Low Index tracks the strongest and the weakest stocks on the exchange and compares their numbers. It measures the balance of power between the leaders in strength and the leaders in weakness. This is why NH-NL is a leading indicator of the stock market. The broad indexes, such at the S&P500, tend to follow the trend of NH-NL.

You can visualize the stocks on the New York Stock Exchange as a regiment. If each stock is a soldier, then new highs and new lows are the officers. New highs are the officers who lead the attack up a hill, and the new lows are the officers who are deserting and running downhill. There are no bad soldiers, only bad officers, say military experts. The New High–New Low Index shows whether more officers lead the attack uphill or run downhill.

When NH-NL rises above its centerline, it shows that bullish leadership is stronger. When NH-NL falls below its centerline, it shows that bearish leadership is stronger. If the market rallies to a new high and NH-NL rises to a new peak, it shows that bullish leadership is growing and the uptrend is likely to continue. If the market rallies but NH-NL shrinks, it shows that the uptrend is in trouble. A regiment whose officers are deserting is likely to turn and run.

A new low in NH-NL shows that the downtrend is likely to persist. If officers are running faster than their men, the regiment is likely to be routed. If stocks fall but NH-NL turns up, it shows that the officers are no longer running. When officers regain their morale, the whole regiment is likely to rally.

From *Trading for a Living*, by Dr. Alexander Elder,
John Wiley & Sons, Inc., 1993

sums up the daily NH-NL for Monday and Tuesday of this week, as well as Wednesday, Thursday, and Friday of the previous week.

Surprisingly few software vendors supply the New High and New Low numbers, but even when they do, those numbers alone are not enough. They need to be processed in a manner described above to make them useful for analysts and traders. Some software vendors process their data in strange ways whose logic eludes me. Kerry Lovvorn, my co-manager of the Spike group, has spent a great deal of time and energy to develop a proprietary method of locating this data and transferring it into TradeStation. He sends out a nightly NH-NL update to all members of our Spike and Spike Spectator groups, and when he is busy I do it for him.

I like to track NH-NL for all listed stocks on the weekly and daily charts (see Figures 1.3, 1.4, and 1.5). The weekly NH-NL helps identify major tops and bottoms, while the daily chart is useful for shorter-term timing.

Another extremely important feature of this weekly chart is that its bearish divergences signal traders when to sell their long positions and

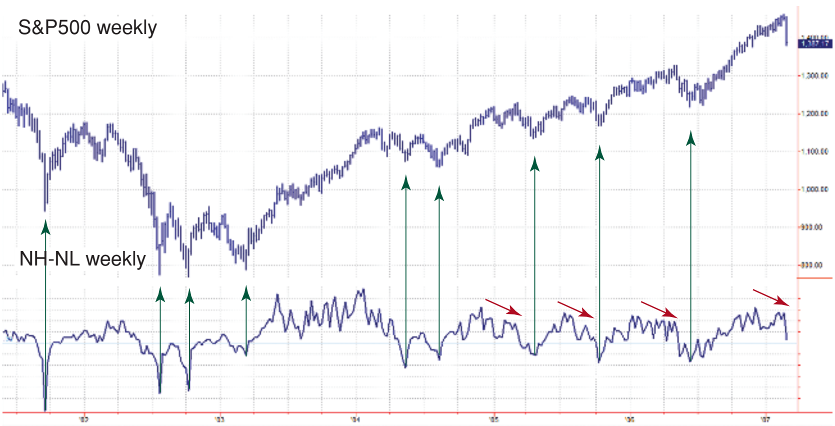

Figure 1.3 Weekly S&P500 and New High–New Low Index

Green arrows—downspikes. Red arrows—bearish divergences.

This chart tracks the behavior of weekly NH-NL during the 2003–2007 bull market. It has two striking features. The first is that every bottom of any importance is identified by a downspike of NH-NL. When NH-NL spikes several thousand below zero, it identifies the end of a bear market and the beginning of a new bull market. This chart shows only three such occurrences, but one can see more of them on a very long-term chart (not shown). In an ongoing bull market, a weekly downspike below –1,000 (minus one thousand) identifies the end of a downtrend and a great buying opportunity. The upspikes carry no such meaning.

go short. Notice that tops are broader than the bottoms and the signals to sell and go short are less precise than the buy signals near the bottoms.

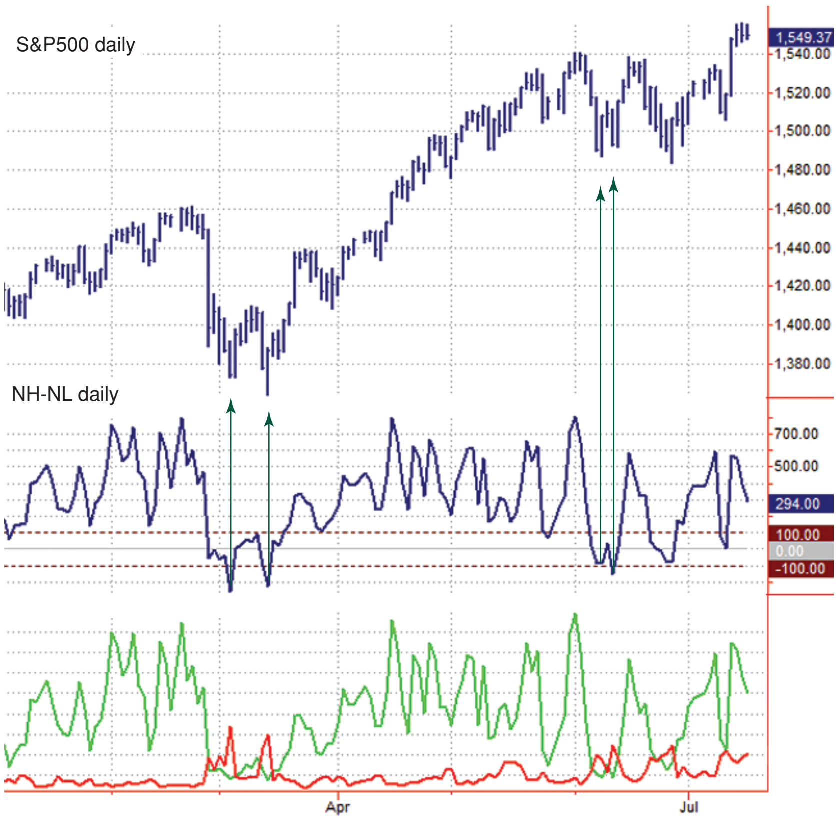

Figure 1.4 Daily S&P500 and New High–New Low Index

Red line—new highs. Green line—new lows. Blue—NH-NL. Green arrows—downspikes.

This chart tracks the behavior of daily NH-NL in 2007. Whenever the daily NH-NL falls below zero, while the bull market is going on, it gives a buy signal. When it becomes negative it marks a brief imbalance in favor of the bears during an overall bull market. That is the time when many people become fearful and bearish, but NH-NL helps counteract their psychological pull. You can see that the daily chart of NH-NL provides excellent buy signals during a bull market but is not too useful for identifying market tops.

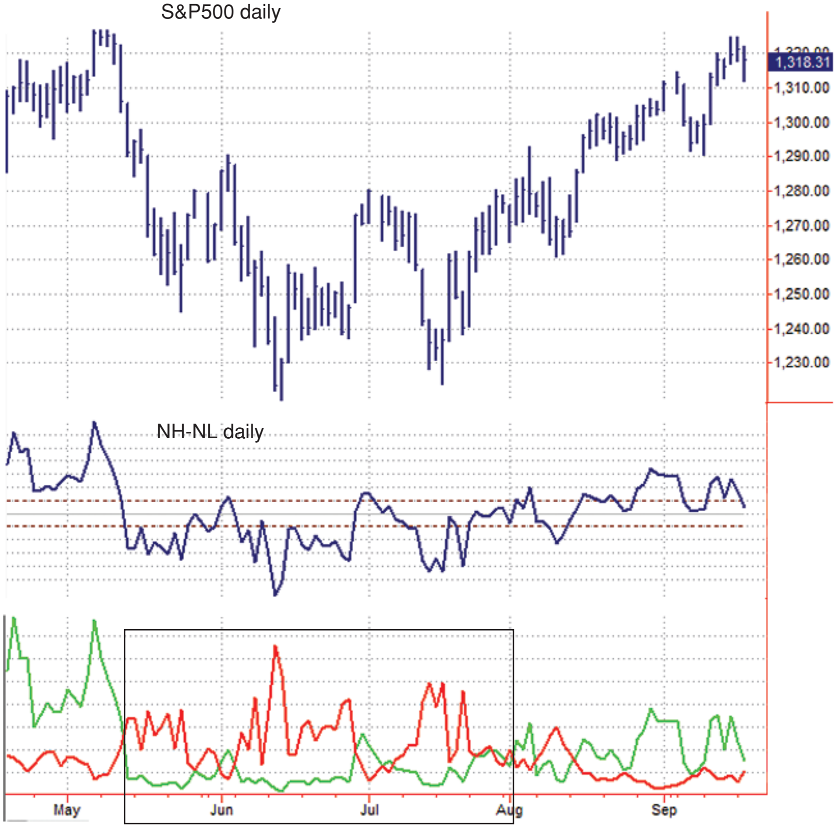

Figure 1.5 Daily S&P500 and New High–New Low Index

The box marks the summer 2006 bottom—new lows stayed above new highs for nearly three months.

The length of time NH-NL stays below zero provides an important indication of the durability of the uptrend to follow. Strong uptrends grow out of solid bottoms, when NH-NL stays negative for two or three months. If NH-NL spends only a few days below zero, it shows that the bottom is not too solid. Even if it leads to a rally, that rally, built on a poor foundation, is likely to end in a severe break.

Another message of these charts is that it pays to keep good notes—a visual diary of your trading and research. You must remember what has gone on before in order to profit in the future.