Finding the Right Trend

This article was written some years ago, but is very relevant to today. The charts used to illustrate the text are now somewhat dated, but still relevant for the present purpose of teaching a technique.

Most successful stock market investment plans involve taking advantage of upward trends in share prices. The difficulty is that trends unfold in many time frames. Clear trends can be seen that play out within a day, continue over many days, run for a few weeks to months and even stretch out over several years. Identifying the correct trend to invest in is one of the more puzzling aspects of stock selection for inexperienced investors.

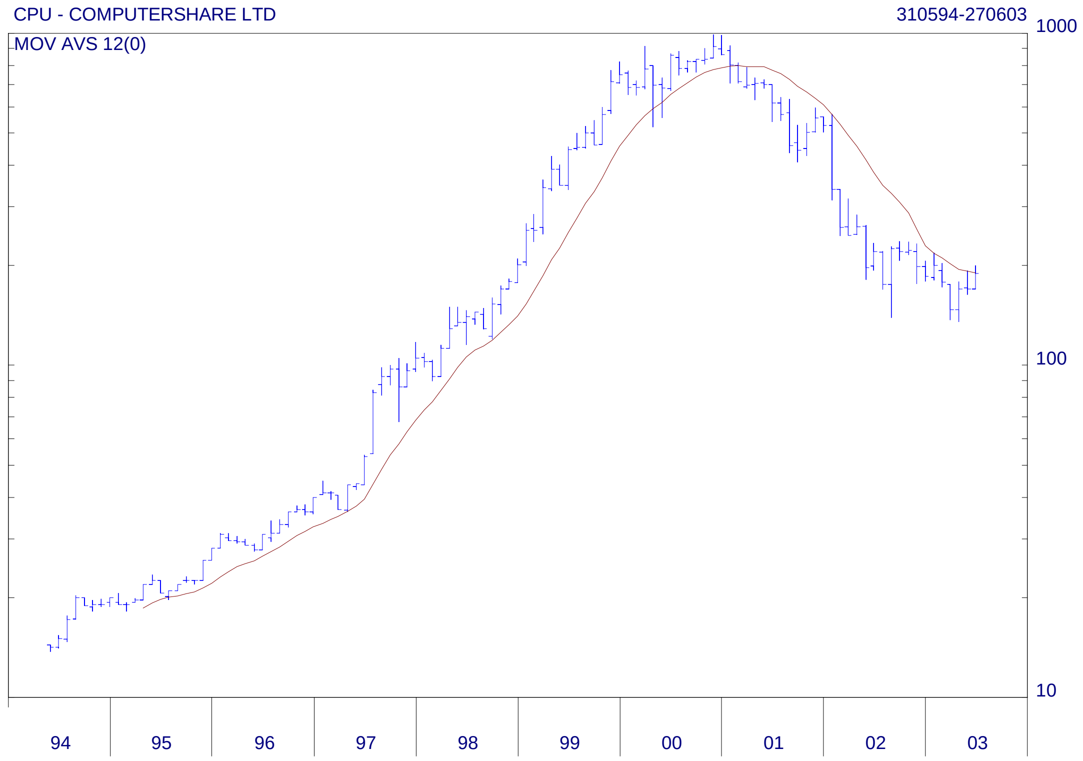
Most beginners tend to get involved in trends that are too short term. This can be costly if they then hold through what they think is only a correction of the uptrend, but which turns out to be the resumption of a longer term downtrend. It is also a wasted opportunity when capital could have been invested elsewhere in a trend in a longer time frame.

The main reason beginners have trouble with this aspect of stock selection is because they have not first thought out a sound investment plan. It should go without saying that we cannot go about finding trends in the right time frame unless we know what timeframe we plan to invest over. It is therefore important to decide whether the objective is to capture the big trends that continue for one to five years, or to capture only the upward legs of these trends, which may involve a far more active investment approach or even a trading approach.

The other main reason that beginners have trouble identifying trends in the right time frame is simply inexperience. There is no substitute for learning the theory and then spending a lot of time studying charts of past prices and actually investing. It is easy enough to teach the theory, but experience is very difficult to pass on to beginners. They simply have to "do the time" for themselves. However, they will learn sooner with a strong theoretical background and by following proven guidelines.

Past articles on the Free and Members website and in my book *Building Wealth in the Stock Market* have explained how a trend is defined. They have also outlined my value and growth models for the two main ways in which the best trends unfold. Undoubtedly the main way in which beginners go wrong is that they look at daily charts with far too little history – sometimes only a few months. They see something that looks like a textbook pattern, but lose money when it fails because the time frame for the trend is too short.

Experienced investors tend to work the other way around. Instead of starting with a short term chart, they begin with a monthly chart with as much history on it as they can get. They then try to see the big trends that play out on such a chart. They look to identify the stock as being a growth model chart, a value model chart or something else that is usually difficult to make into an opportunity. For the growth and value model charts, they then look for the ones that are currently beginning uptrends or where the uptrend has not yet run too far.

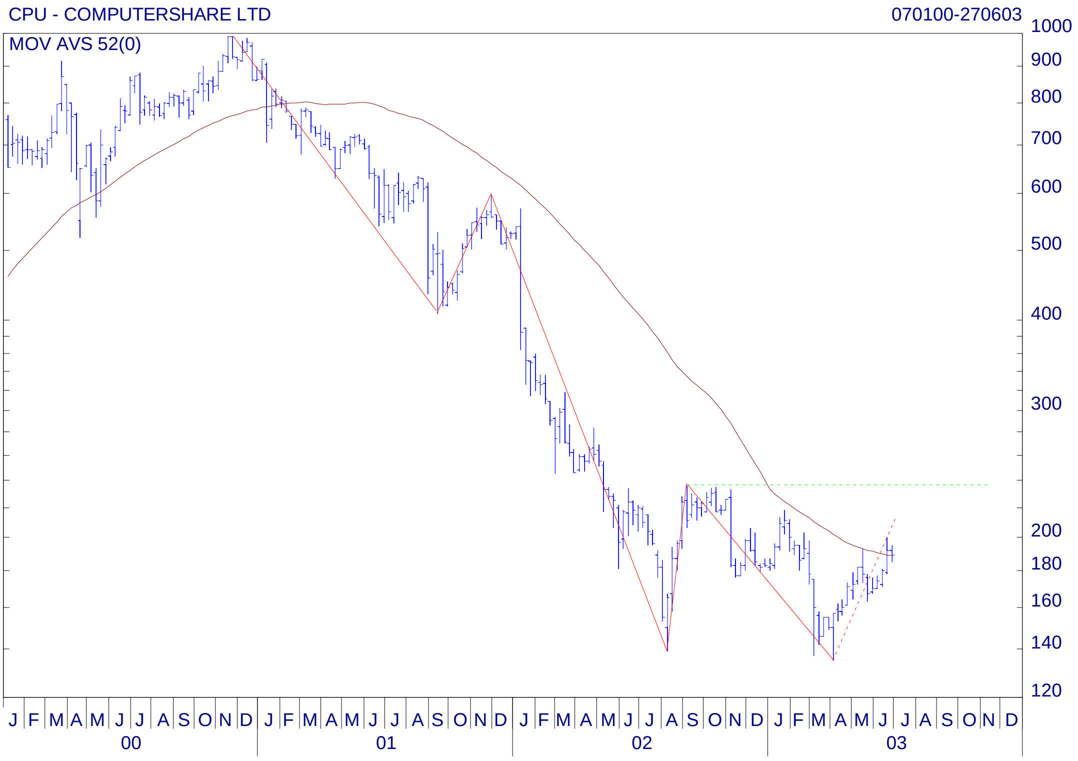


As an example, examine the monthly bar chart of Computershare (CPU) from listing in 1994. I find that a 12-month (or 52-week or 260-day) moving average helps to define the big trends on the chart. When looking at long term monthly and weekly charts it is advisable to always use a semi-log chart (price on a logarithmic scale and time on a linear scale) so that a true perspective is obtained in terms of relative change in price at various levels on the chart. Using a linear chart for a stock like this would suppress the importance of price action at lower prices at the start and finish of the Computershare chart and make it much harder to see the chart in a useful perspective.

The chart shows a big uptrend from 1994 until the end of 2000. This is clearly a growth model example because it developed with numerous mark-up periods interrupted by periods of consolidation, but few significant corrections of the trend. However, from the start of 2001, the trend turned down. At mid-2003 it looks as though it MAY be levelling out. This suggests that it could be forming an accumulation zone and is going to perform in future more like a value model chart. This is not unusual when erstwhile growth companies move into more mature phases of their life cycle.

The moving average helps us to see this pattern. Its rise was uninterrupted through to the end of 2000. After that it levelled out and then fell continuously until recently when there is a tendency for it to be levelling out.

The next step is to examine a weekly chart. Around four years of history on the weekly chart is appropriate. However, it is more important to capture the entire last major trend. In the case of Computershare, this would be the three-and-a-half year period from the start of 2000 to mid-2003.



The weekly semi-log chart has a 52-week moving average on it, which is essentially the same as the 12-month moving average used on the monthly chart. The major swings of the downtrend have been marked in solid red lines. Since the last swing is incomplete, it is marked in a dotted red line. Within each of these major swings are shorter term swings that have not been marked, because they relate to a shorter time frame.

The swings have traced out a clear pattern of lower peaks and lower troughs. This pattern is unbroken at the end of the chart, so the major trend is still down. For the trend to change at this point, Computershare would have to rise above the last major peak. That level is marked on the chart with a green dotted line.

The trend is also noticeably losing momentum. The moving average is flattening out. The last down swing was shorter than previously and only just managed to fall lower than the previous trough in mid-2002. All of this suggests that an accumulation area MAY be forming. However, that is only a working assumption until it is complete. Even the best companies can fail to complete patterns like this and go much lower. It is wise never to anticipate trend changes, something that is impossible to do with any consistency.

So, for the investor, this chart will be interesting to monitor for the potential emergence of a new major uptrend. It could happen soon, or after a lot more accumulation, or the pattern may fail completely.

Traders will be operating off the daily chart. The recent swings have been marked in red as on the weekly chart. Within them there are also shorter swings that are not marked.

There is a clear double-bottom pattern followed by a short term uptrend that is forming a leg of the big down trend and is still in progress. Very active investors and traders could be participating in this trend and will be watching it anxiously as it struggles with the resistance level that is presently challenging its progress.

Shorter term traders will have traded the first upswing from the double bottom and got out when it failed. They might then have bought back into the current upswing and may or may not be still in such a trade, depending on their exit rules.

This method of analysing a stock starting with the monthly chart, working down to the weekly and finally the daily chart is a key guideline in developing the experience to correctly match trends to your investment time frame.