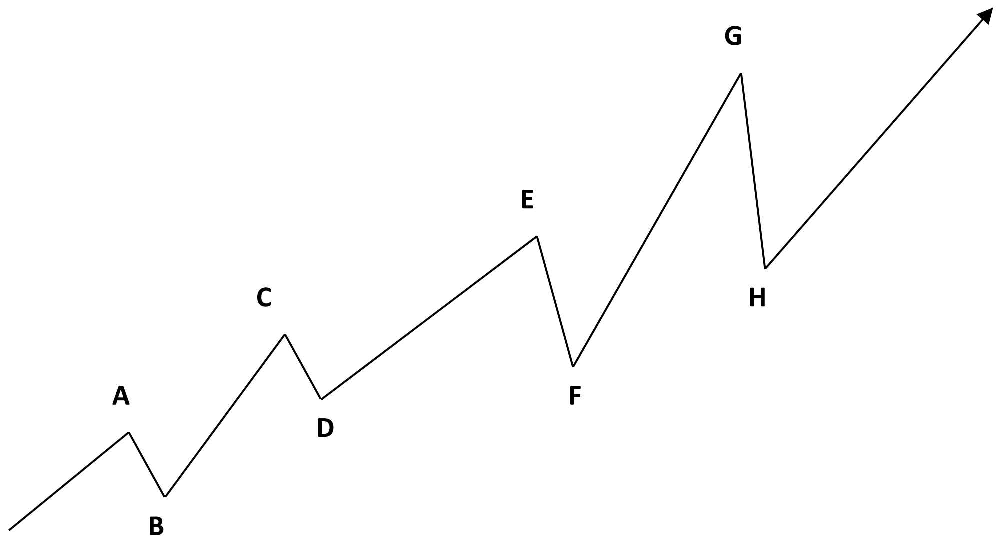
How to Get on Board a Good Uptrend

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.

Finding an uptrending stock that is cheaper than the general run of stocks on the market is only the starting point. While many beginners think that all they need to do is find the right stock and buy it, they soon find out that it is unfortunately never that simple.

The next thing is to be clear about whether we are going to be a trader or an investor. Unless we are sure about this, it will be difficult for us to make the right decisions. Indeed one of the most common faults seen in beginners is that they buy a share as an investor and then start watching it like a trader. Inevitably they sell at the wrong time and miss much of the potential gain. Almost as bad is buying a share as a trader and then letting it become a losing long term investment.

An uptrend develops as a series of rising peaks and troughs, as shown in the diagram.



If we are intending to be a short term trader, our strategy should be to buy near B and sell near C, then buy near D and sell near E, then buy near F and sell near G, then buy near H and sell when we see evidence of another peak. In other words, we try to capture as much as we can of each upswing in the trend and stay out of the downswings. If we are a short term trader, there are two key mistakes we should try to avoid.

The first mistake we can make is to miss the start of a move, probably because we are uncertain about it, then rush in too late and end up buying near the peaks (A,C,E and G). The second mistake we can make is to not act quickly enough when a peak is reached, so that we hold on too long, give back our profit and maybe make a loss. The first mistake comes from a lack of courage and the second from a tendency to be too greedy.

If we are intending to be an investor, our strategy will be quite different. We will want to identify the overall trend as early as we can and stay invested until we are sure that the trend is finished. The big advantages an investor has over a trader are that transaction costs are less, they capture more of the overall trend, they have fewer decisions to make and their taxation situation may be better if the trend lasts over 12 months.

If we are an investor, there are two key mistakes we should try to avoid. The first mistake we can make is to sell out prematurely in one of the downswings, so missing the potential gain. The second mistake we can make is to stay too long after the trend has ended. The first mistake comes from a lack of courage and the second from 'falling in love with the stock', or hoping for the best in the face of clear danger.

The most important thing to understand about the key mistakes made by both traders and investors is that unless what they are trying to do is absolutely clear in their mind, they will inevitably make one or both of the mistakes described.

While the buying decision is less critical for them, investors will still achieve a better profit when their purchase is made near one of the troughs in the trend rather than near one of the peaks. Otherwise, they will have to sit through an initial loss on paper before their investment begins to work. Their stop-loss level will also be closer to their entry price.

Another important problem for investors is the psychological one of fearing that the trend they have found has already gone too far and they have missed the best part of it. They will therefore pass up good opportunities. Experience shows that strong trends tend to persist longer than we expect. It pays to buy into strong trends, providing the stock is still cheap. However, it will be safer if the investor buys near one of the troughs in the trend.

So, both the trader and the investor should be looking to identify when they are near one of the troughs in the trend. I say 'near', because there is never any certainty in trading and investing - only probabilities - and experience shows that it is extremely difficult to pick the exact bottom of the troughs.

There are a number of ways in which traders and investors can use charting and technical analysis tools to identify when they are near a trough in a trend. The main difference between the task of a trader and an investor in this respect is the time frame of the chart and data they will use.

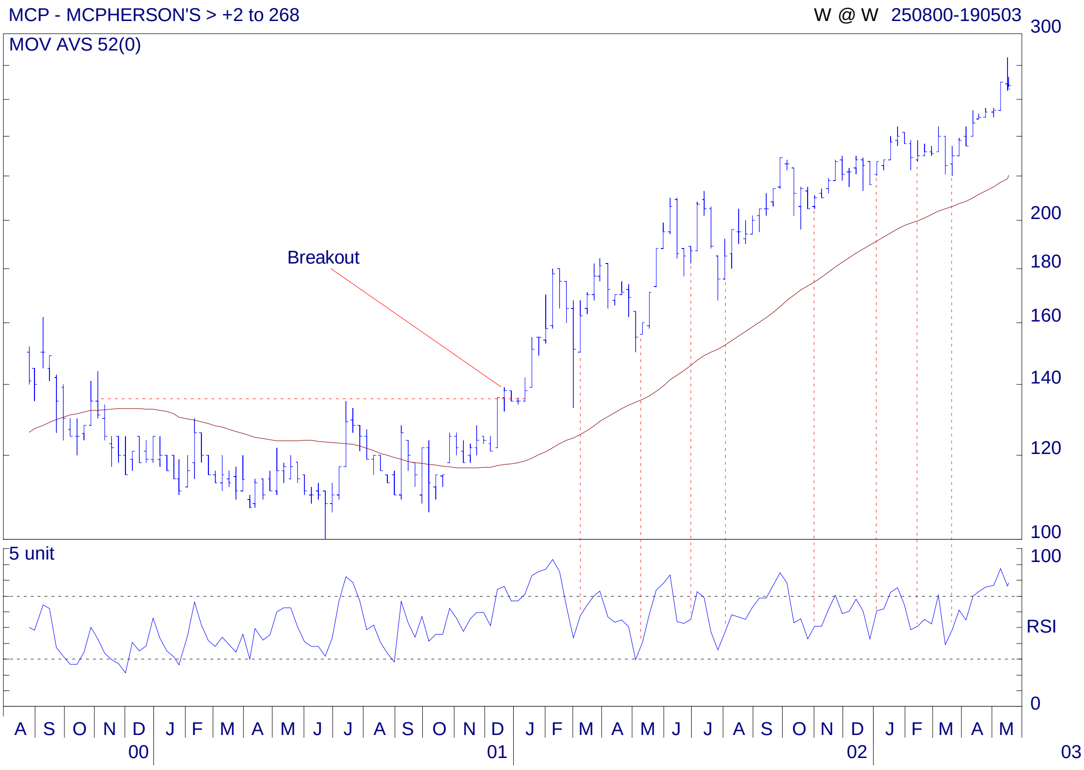
Traders will use a weekly chart to assess the main trend and a daily chart to find their entry point. Very short-term traders and day traders will use a daily chart to identify the main trend and an intra-day chart (say five or ten minute bars) to find their entry point.

Investors will use a monthly chart to assess the main trend and a weekly chart to find their entry point. They may then use a daily chart to fine tune their buying tactics.

A wide range of possible charting and technical analysis tools may be employed by both traders and investors. There is no 'perfect' method. All of them work really well sometimes and less well at other times. The final choice of which tool to use will often depend on the personality of the trader or investor – what they feel comfortable with. More sophisticated traders and investors will choose the tool that they feel will work best in the situation they see on the chart. This requires a lot of experience and judgement that can only come over time.

Some of the methods that can be employed are:

1. If the trend unfolds in a very orderly manner, buy near an established trendline.
2. If the trend unfolds so that its troughs tend to be near a moving average line, buy when the price returns to or near the moving average.
3. Study the downswings in the main trend on a shorter term chart and look for a signal that the downswing has ended. Trendline breaks, moving average violations, trend analysis of the highs and lows of the bars and short-term reversal signals can all be useful here.
4. Buy when a momentum oscillator turns up.



The above weekly bar chart of McPherson's shows how the uptrend developed once MCP had broken out of the sideways pattern it had been in from late 2000 and through all of 2001. In the sub-chart under the bar chart, is a popular momentum oscillator: a 5-week Relative Strength Index (RSI). There are many ways to use the RSI. One of them is to enter a trend near the troughs in the RSI.

The RSI swings up and down. Whenever it makes a strong down move and turns up, there is a good chance that we are within one or two bars of a trough. The vertical red dotted lines show these signals. An investor who bought on any of these signals would have achieved a reasonable entry price at that stage of the trend. They certainly avoided buying near the peaks.