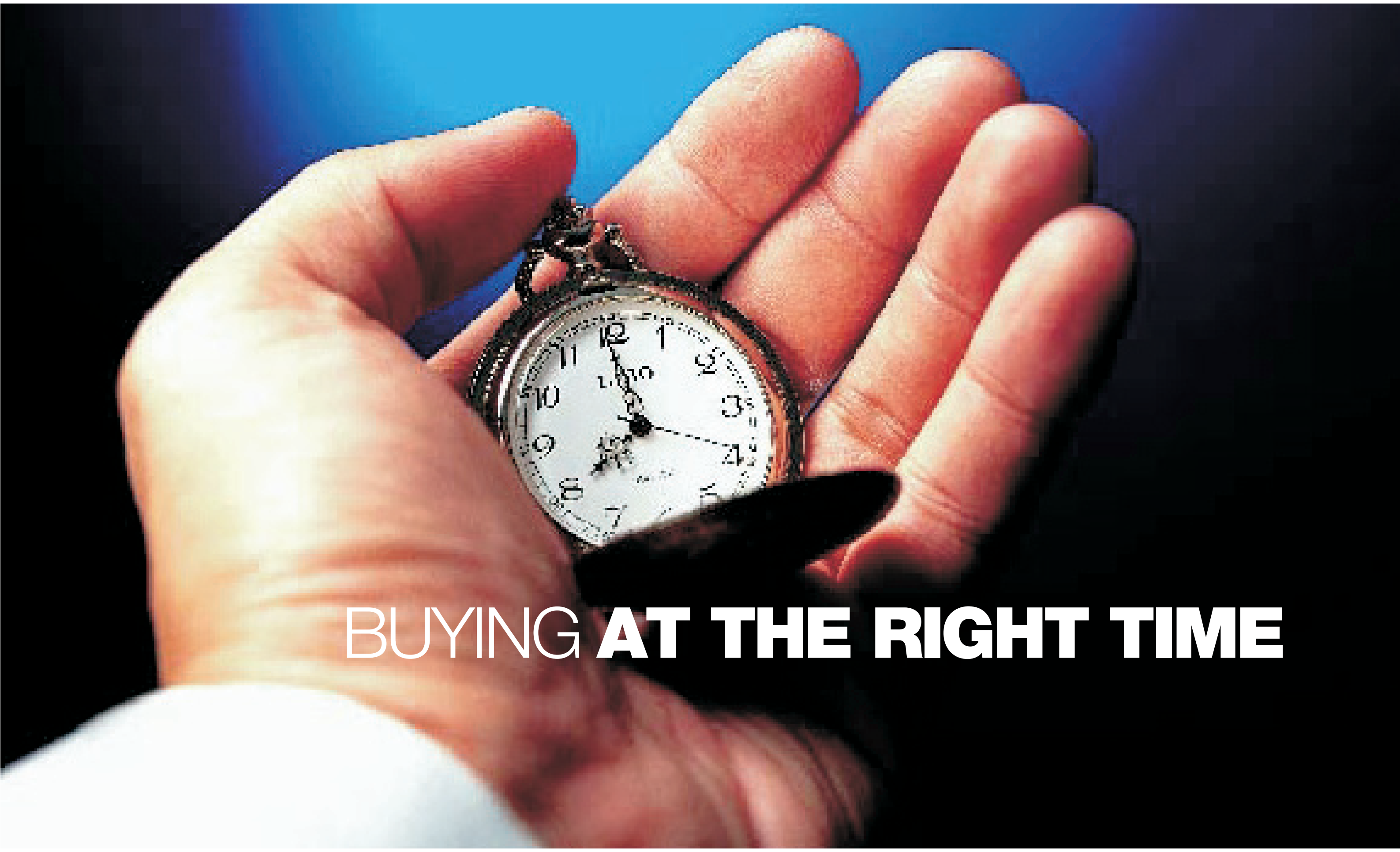
By Ng EeHwa – ChartNexus Team



BUYING AT THE RIGHT TIME

With so many concepts such as support and resistance, trendlines, chart formations and indicators in Technical Analysis (TA), it can become confusing when applying theory into practice in actual stock market trading. This article explores how we can develop an effective strategy that incorporates some of the important aspects of TA to improve our odds.

The strategy discussed in this article comprises of the following concepts:

- **Support and resistance**
- **Trendlines**
- **RSI**
- **Stochastic**

Support & Resistance

Support and resistance levels are price levels that offer support to downward price movement and resistance to upward price movement respectively. This is a classic example of market psychology where market participants tend to remember some key levels, consciously or subconsciously monitoring them when the prices approach these price levels. As an example, when price retraces to a previous low, traders and investors will buy the stock as they perceive that the price is "low" thus providing support to any further downward movement and this price level is referred to as horizontal support level.

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Figure 1: Example of support and resistance

Figure 2: Example of trendlines

In addition to the example above, support and resistance levels can be obtained from trendlines, chart formations, price gaps, candlestick patterns and moving averages.

Trendline

Trend analysis is the essence of TA. However it is one of the most commonly misused concepts. An uptrend is identified by a series of higher lows and higher highs, with an uptrend line drawn by connecting the lows of the price structure. This uptrend line acts as support to the price movement. Conversely, a downtrend is identified by a series of lower lows and lower highs and the downtrend line is drawn by connecting the highs that serve as resistance to the price movement.

As multiple trendlines can be drawn on a chart, it is important to identify the ones most likely to have a significant effect on the immediate price structure. Figure 2 shows the key trendlines that were driving the price structure of StatsChP in 2005 and early 2006. We can observe how the support and resistance concept introduced in the previous section can be applied here. During the uptrend in early 2005, the blue trendline was supporting the upward price movement. However from the moment it was broken in August 2005, the same blue trendline resisted upward movement in price. Extending this blue trendline shows that it still had a resistive effect on the price movement in May 2006.

Thus, identifying the significant trendlines and the extended trendlines is crucial in TA as they provide strong indication of whether a reversal (either short-term or long-term) is taking place through the breaking of the trendline.

Technical Indicators – RSI & Stochastic

Many technical indicators abound. Nonetheless, we will focus on two popular indicators, namely Relative Strength Index (RSI) and Stochastic. Both RSI and Stochastic are oscillators that reflect the momentum of the price movement. It is important that we observe the different interpretations of the trading signals from these two indicators. A trading signal from an oscillator is obtained by specifying one upper level and one lower level. When the indicator is below the lower level, it is considered to be in oversold condition while a reading above the upper level is considered to be in overbought condition. We have to be careful in our interpretation to avoid buying in a strong downtrend or shorting in a strong uptrend. We will elaborate in the subsequent section.

A Simple and Effective Strategy – Putting the Concepts Together

A trading strategy based on the concepts of support and resistance, trendlines and technical indicators is effective, and coupled with careful money management may yield significant positive returns to the trader.

The steps to create such a strategy follow (for simplicity, we will assume only a long or buy strategy):

(a) Identify stocks that are in a major uptrend

(b) Identify important support and resistance levels

(c) Identify stocks with RSI or Stochastic that are in oversold condition

As an important saying in TA goes "Trend is your friend". It is important to trade with the trend. Essentially, for a long strategy, we start by identifying uptrending stocks.

Next, we look at the support and resistance levels to discover potential stocks that offer good risk-reward ratio. As a general rule, look for stock prices that are near significant support levels and far from the significant resistance levels.

Finally, filter stocks with RSI or Stochastic that are in oversold condition, allowing us to buy when the price is retracing within the uptrend movement. It is important to note that if a stock is in a downtrend, the oscillator may stay in the oversold region for a long time and it is thus not a good idea to time your entry in a downtrending stock based on the oscillator's oversold signal.

This trading strategy allows us to time our entry in up-trending stocks whose prices have retraced and are ripe to resume its uptrend. An example is shown in Figure 3 where we apply the above rules by entering on 29 September 2006 just after the price of Sino-Env retraced slightly before resuming its uptrend.

This article has introduced a simple but effective strategy of timing the entry for uptrending stocks. While there are other strategies freely available, it is important to understand the setup required for any strategy selected. If possible, it is advisable to carry out a backtest (simulation on historical data) on the strategies to ensure their effectiveness. ■

Figure 3: Example of applying the proposed strategy on Sino-Env

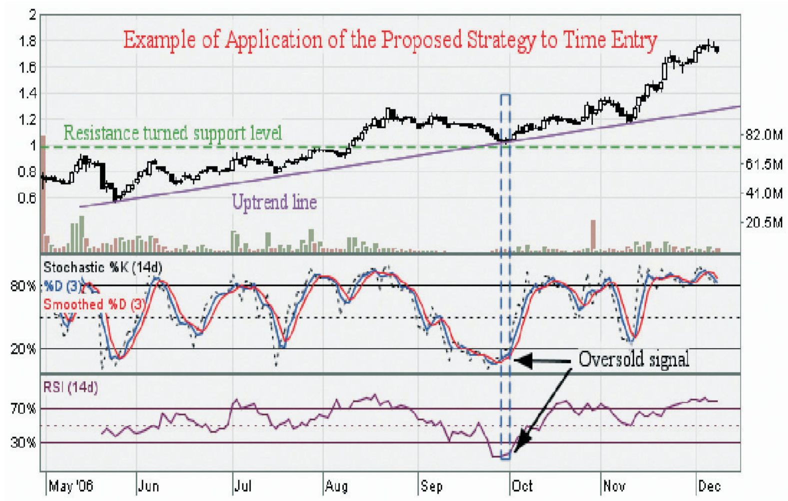
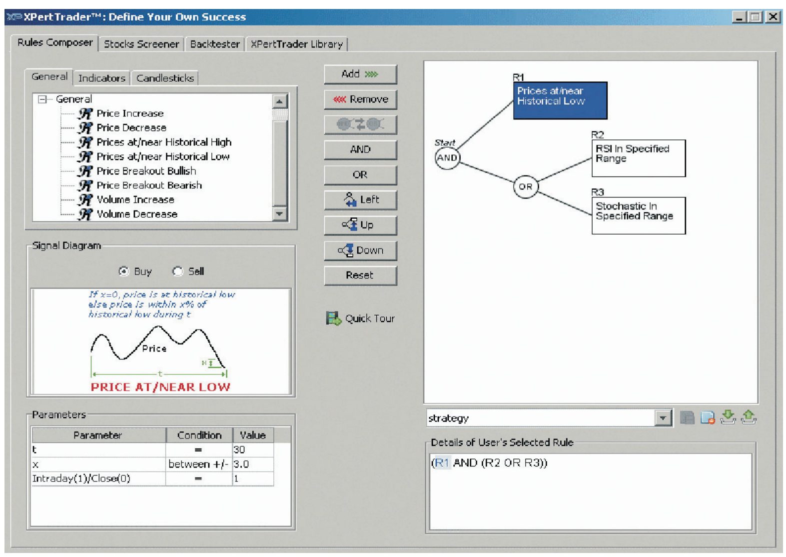


Figure 4: Software such as ChartNexus XPertTrader simplify the process of screening the whole market for technical signals, saving you time and effort to uncover potential "gems"



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