NADIR KIANERSI

Rediscover The Basics

Finding Low-Risk Entry Points

Sometimes you have to go back to the basics, especially when you hit a rut. One of the most basic technical indicators you can go back to is the moving average. It works well in trending markets but it also has its shortcomings. Here's how you can use it to your advantage.

by Danish Kapur

Several myths are tied to the use of moving averages. Here, I will try to simplify the implementation of moving averages and clarify some of the more popular myths associated with them. Moving averages are one of the simplest tools available to a trader, and they can be of great help in identifying potential low-risk entry points. But you can't take them for granted.

There are different types of moving averages such as the simple moving average (SMA), exponential moving average (EMA), and weighted moving average (WMA). I will focus on the SMA, which is the arithmetic average of prices over a specified period of time.

IT'S SIMPLE

Moving averages are helpful in determining the direction of a trend, but if a market is in a trading range, you are better off using another type of indicator. In addition, there is no "one size fits all" parameter to use for moving averages. You may find the 50-day SMA works well for one stock but not for another. Different moving averages work for different markets and you

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FIGURE 1: 250-DAY MOVING AVERAGE ON THE SENSEX. The 250-day moving average worked very nicely in giving the right entry points at (1), (2), (3), and (5), which on the longer-term time frame gave good opportunities to add to existing long positions. Even after the prolonged correction, the Sensex's relationship with the 250-day SMA remained in effect (as you can see the prices bouncing off after hitting point 5).

need to do your due diligence when it comes to determining which SMA to use. Discretionary traders can do this by applying the SMA to a chart and checking to see how well prices respect that specific moving average. System traders can determine how well the SMA performs by backtesting and analyzing its performance.

Also keep in mind that markets are dynamic, so their relationship with the moving average can change over time. If the market were more responsive to a particular moving average a few years ago, that does not mean it will remain that way forever. It may now be better traded with another moving average. You need to be mindful of the changing circumstances in the market.

Getting into the habit of periodically backtesting a particular moving average will put you in a situation where instead of forcing a moving average on the market you will let the market determine what moving average works best.

Golden cross or death cross?

You all have heard stories about the death cross and golden cross. The golden cross occurs when a shorter-term moving average crosses above a longer-term moving average indicating a shift from bearish to bullish mode. The death cross indicates a shift from bullish to bearish mode and occurs when the shorter-term moving average crosses below the longer-term one.

I don't take such terms seriously because moving averages are lagging indicators, and by the time the death cross or golden cross is generated, it is often too late to manage the trade. These crosses are often found to be false signals and rarely do they generate a buy or sell signal at the right time. Money is made by sitting on the right trade for the right length of time and not by constantly exiting and reentering.

Applying moving averages

Moving averages are most helpful when used to add to an existing profitable long position. My focus will only be on long trades for this article. Here is how I use moving averages:

1 I identify the trend using my swing trading methodology. (For an introduction on swing trading, see my article mentioned at the end of this article.) If a market is making higher tops and bottoms, the trend is up (go long); and if market is making lower tops and bottoms, the trend is down (go short).

2 Once the trade is executed and shown to be profitable, use moving averages to identify potential entry points to increase your position size.

3 Exit the trade when the trend changes (again based on swing trading methods). Do not wait for moving averages to tell you when to exit. That could be too late!

My focus has been to stay away from rigid rules and be as flexible as possible while paying close attention to risk management. Knowing the risk is most important in any trade.

Some examples

Let's look at examples of how one market responded more favorably to one particular moving average (MA) and how another market would have been traded better with a different MA. When the moving average was broken on the downside, the same MA acted as strong resistance, as can be seen at point (4) in Figure 1. Similar behavior can also be seen in Figure 2.

In Figure 1 you see the daily price of the Sensex with a 250-day SMA. As you can see, the 250-day moving average worked well in giving the right entry points at 1, 2, 3, and 5, which on the longer-term time frame gave good opportunities to add to existing long positions. Even after the prolonged correction, the Sensex's relationship with the 250-day SMA remained in effect (as you can see, the prices bouncing off after hitting point 5). As long as the trend is up, I would continue to add to my long positions when prices hit the 250-day

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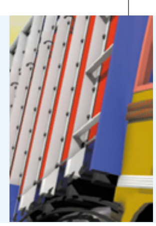

FIGURE 2: 150-DAY MA ON THE DJIA. The 150-day MA works better than any other in helping to identify potential long-term buy points. As you can see, the entry points 1, 2, 3, 4, and 5 were helpful in adding to existing long positions.

moving average.

In the chart of Dow Jones Industrial Average (DJIA) in Figure 2, you'll see that the 150-day SMA works better than any other in helping to identify potential long-term buy points. Entry points 1, 2, 3, 4, and 5 were helpful to add to long positions.

What should you do if the market that is in an uptrend were to go below the moving average (as happened in the DJIA in Figure 2 after point 5 or 3)? Well, no one can figure out in advance whether prices would bounce back from its moving average, so the best thing you can do is buy when price comes down to the moving average and keep holding the position as long as the trend is up.

When the trend shows signs of turning down, it is time to exit all the long positions. It's best to apply an indicator such as an oscillator to determine if the trend is turning down.

Another possibility that could arise is when the market turns from a trending one to one in a trading range. As you can see in Figure 2, that is what happened with DJIA during the first few months of 2010. The market turned sideways, and the best advice would have been to hold long positions as long as the uptrend was in effect. We knew the uptrend was in effect because we use swing trade methodology. After point 5, we went sideways but never decisively broke the last major bottom, although we did have intraday movements a few points under that. But there was never a sharp drop and the intraday trading pattern also tells you the bias was always up. As long as the last bottom is intact, the trend is up.

Finally, I would like to show you an example of a death cross (50-day moving average crossed below the 200-day moving average from above) in the DJIA (Figure 3). In spite of the death cross, the market kept going up. As you can see in the chart (circled), the death cross occurred in early July 2010, and a few days later, there was the golden cross. Entering or exiting based on these signals would have ended up being more stressful and less profitable, since it would have been close to impossible to time those entries and exits perfectly.

FIGURE 3: DEATH CROSS IN THE DJIA. The death cross occurred in early July 2010 and a few days later the golden cross occurred. Entering or exiting based on these signals would have ended up being more stressful and less profitable since it would have been close to impossible to time those entries and exits perfectly.

STICK TO THE PLAN

As I mentioned, these whipsaws are the main reason I like to avoid using moving averages for buy or sell signals. The crucial point in trading should be to remain flexible and simple. Simplifying the rules makes a trade relaxed and profitable.

Danish Kapur (www.danishkapur.com) is a trader and follows both Indian and US markets.

SUGGESTED READING

Kapur, Danish [2008]. "Swing Trading And Market Pace," At the Close, *Technical Analysis of* STOCKS & COMMODITIES, Volume 26: September.

‡Bloomberg Finance