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FOURTH EDITION

THOMAS J. DORSEY

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Point and Figure Charting

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Point and Figure Charting

The Essential Application for Forecasting and Tracking Market Prices

Fourth Edition

Thomas J. Dorsey

Wiley

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ACKNOWLEDGMENTS

It's been 17 years since the first edition of *Point and Figure Charting* was printed and 26 years since Watson Wright and I walked down Main Street in Richmond, Virginia, to our new quarters to launch Dorsey, Wright & Associates (DWA). Watson and I were together for the better part of 32 years in total, almost as long as I have been married to my wife, Cindy. Watson and I found a way to make 1 + 1 = 3. Our partnership worked well for 25 years. In 2011 Watson decided a 32-year career on Wall Street was enough and he retired. Bravo to you, Watson. May your golf handicap approach zero!

The first edition of *Point and Figure Charting* was a labor of love. I knew it had to be written if for no other reason than to express my gratitude for having been shown my manifest destiny to help others become great at investing, and giving me a vision to develop DWA with Watson. The second I learned this method of investment management I knew I had to pass the word to any and all investors who are searching for a more secure financial future. The success of the first edition and the consistency of sales told me this was the right method for the majority of investors. When John Wiley asked me to write the second and third editions I knew we would be here for the long haul. We have developed many new concepts for Point and Figure analysis over the years similar to the spokes extending from the hub of a bicycle wheel. My two top analysts, Tammy DeRosier and Susan Morrison, joined in with me in writing the second and third editions and I roped them into proofing a few chapters of this book. Tammy and Susan have been with DWA since the beginning and are like family to me. They have accumulated 25 years each in experience in this method of investment analysis. Tammy is

now my COO and Susan is head of Research, two very important jobs. In my opinion, they are the best on the planet when it comes to our little slice of Wall Street. The third-longest employee here, and also like family to me, is Jay Ball, who heads up all of our technology. This is a massive job as we have the largest portfolio charting system on the Internet today. Our DWA Database, which I like to call the Dorsey, Wright Productivity System, has expanded and evolved over the years to reflect our cutting edge research. Jay has been the key architect in the web site's design and development, and has done a yeoman's task, sacrificing many nights and weekends to be sure this system keeps running to service our clients' needs. Over the years we have had a great group of analysts join us; Steve Raymond, Paul Keeton, Jay Gragnani, Chuck Fuller, Ben Jones, Amy Kemp, Sydney Seik, and a group of interns that are second to none. James Fisher, the newest addition to our team, does a fantastic job as our VP of Finance. Without Nancy, our office manager, the office does not function.

In 1994, we formed Dorsey, Wright Money Management in Pasadena, California, under the guidance of Mike Moody and Harold Parker. Andy Hyer and J. P. Lee do a great job in marketing and client services for this division; and our portfolio managers (John Lewis, along with Mike and Harold) have developed excellent asset management products and services, such as our fantastic Technical Leaders line-up of ETFs. At this writing we have approximately $2 billion in assets under management—and in my mind, the sky's the limit!

One of our newest, oldest employees is Sara Giegerich. She is one incredible lady. She first became an intern at DWA during her high school career. She graduated and went on to the University of Virginia, still working at DWA on all holidays and summers. When she graduated from UVA she went to the University of Georgia School of Law and continued to work here all holidays and summers. It was amazing to me to watch her develop not only as an analyst, but also an all-around person who knows everything about the workings of DWA. This was the perfect training ground for her new position as our corporate attorney. She is not unlike all analysts at DWA who have worked here through college, but Sara has the most accumulated time at the job working in many different positions. I look over at her each day and all I can do is smile. Sara was my driving force in writing this fourth edition. Her organizational and English skills pushed me forward to the end. She has proofed every chapter not only as a project manager, but as an analyst who understands every facet of this book. Having been around me all these years, she knew exactly how to use

the "cattle prod" to keep me moving. It is difficult to work full time and devote your spare time to a book like this. Both she and I have spent many weekends immersed in the construction of this fourth edition. Thanks so much, Sara, for your dedication to DWA and your dedication in helping make this edition a success.

As with everything we do at Dorsey, Wright, this book is a family affair. I hope you enjoy the book; our heart is in it.

PART I

Learn the Point and Figure Methodology

CHAPTER 1

Introduction

Point and Figure Charting: A Lost Art

I would never have thought we would be embarking on the fourth edition of this book when I wrote the first edition. I know now that this will not be the last edition either. Technology has significantly changed the way we approach technical analysis and the way we implement the art of portfolio management. The Internet has provided a delivery system we could not have imagined when I was a stockbroker at Merrill, Lynch, Pierce, Fenner & Smith in the 1970s. What I mean by that statement is that computers can now do most of the work for you. We have taught the computer to do exactly what we used to do by hand 25 years ago. The operative word there is *taught*. The computer can only do what we tell it to do. Somewhere in the future it might do its own thinking, but at this writing, it has to be told. Think about medical technology for a second. I have a friend who is going to be operated on next week by a robot. To me this is *The Jetsons* revisited. *The Jetsons* was an animated sitcom that debuted in 1962. It was about a Space Age family living in the future (the exact opposite of the animated sitcom *The Flintstones,* which was a family living in the Stone Age). Much of what was depicted in that weekly show has come to pass. Think of how automobiles can now parallel park by themselves. Robots can perform operations on humans but only under the eye of a trained surgeon. We have gotten to the point where a surgeon-guided computer can actually perform the operation with more skill than an unassisted human, just like computers can outplay world-class chess players as "Big Blue" did against Gary Kasparov and later the computer "Watson" outplayed the best contestants on the TV game show *Jeopardy*. The computer does exactly what

it is told with no emotion and no mental or physical fatigue (if you don't think mental and physical fatigue come into play with regard to portfolio management, think again). Google has transformed how we deal with ordinary medical conditions that used to require us to see a doctor for advice. Today, most people simply "Google" the symptoms and thousands of informational pages instantly appear. It still amazes me. Naturally, if the online remedy didn't work, you would go to your doctor, but only after you searched the Internet for a solution. Investing is the same today. On our system you could search for, say, a list of high-dividend stocks in the Oil Service and Utility sectors. Then you could simply click a button and the DWA Matrix system would perform an extensive "relative strength arm-wrestling contest" among all the stocks, and then order the list from best relative strength to worst relative strength in the group. It would only take a matter of minutes to perform these tasks. Then an investor could click a button to buy at the market the top 5 or 10 on the list. After that, a program could be set to sell any stock that dropped to a certain level on that relative strength list and replace it with a purchase of the next strongest stock. Think I'm kidding? The technology is already here at Dorsey, Wright & Associates (DWA). It is amazing to me that we have this capability relative to where we were only 10 years ago. In a matter of minutes you could create a good income-producing portfolio ready for investing. But without reading this book carefully, you would not understand the underlying concepts used in this computer search. This book is the first rung of the ladder on your climb to becoming a world-class investor. Questions you will learn to answer before you take full control of your investments include:

- Which asset classes are in favor?
- Did you search the right sector?
- Is the market in a mode to support higher prices?
- What countries are the best places to invest?
- What mix of bonds and stocks should you have in your portfolio?
- Should you use stocks, exchange-traded funds, or mutual funds to populate your portfolio?

There are many questions that need to be answered to stack all the odds in your favor, but once they are answered, let technology do the driving. You see, you are still an integral part of the equation. This goes for professionals

and individual investors alike. There are two kinds of investors—those who want to use the quarter-inch drill and those who simply want the quarter-inch hole. Harvard marketing professor Theodore Levitt illustrated this difference with this straightforward analogy: "People don't want to buy a quarter-inch drill. They want a quarter-inch hole!" You know what? I so believe in the quarter-inch hole concept that I had my niece Meghan Hartsoe, who is an artist, paint me a black hole on a canvas—nothing else but a creatively drawn hole. I want Dorsey, Wright Analysts to always keep this concept in their minds as we write research and develop new products to serve the investment advisory business.

Over the years, we have all experienced many medical difficulties and have learned from them. When we have a cold, we automatically know what over-the-counter medication to take for it. If we have a scratch that becomes infected, we know exactly what to do for it. We have many years of hands-on knowledge about simple health problems we all encounter on a daily basis. In the investing world, you don't have these basic life skills we acquire just by being alive. You have to learn them. What were the telltale signs that 2008 was going to be a terrible year for investor portfolios? How did anyone know that the banking sector was in deep trouble and the stocks underlying it were about to fall? You certainly didn't learn it from the financial newsprint or financial TV. If investors could learn anything from reading or watching these forms of media designed to give investors a heads-up, there would not have been 13 trillion dollars of American household net worth lost in the meltdown. These are the things you will learn in this book that will eventually become intuitive to you. When you have a working knowledge of the material in this book, you will then be ready to let the computer do the work. Just like doctors let robots do the work today and airline pilots allow planes to land with no human assistance, you, too, will be ready to let technology do the work and have it delivered to you on your mobile device. One of the largest deterrents to successful investing is encapsulated in one word: *emotion.* Computers don't have emotion; they only do what they are told to do. They don't watch CNBC or read the *Wall Street Journal.*

In learning this method it is always best to maintain some charts by hand. Nothing will give you a better feel for it. Even though the computer is updating the same chart automatically, when you put that one extra "O" in the chart as you update it by hand, and that "O" completes a certain pattern you know has statistical significance, it's an "aha" moment you won't forget. So, yes, it is important to learn the craft before you allow the computer to take over. Take the time to read this book carefully, underline, take notes, take it

page by page, and in the end you will be well rewarded. Remember, "life's a cinch by the inch; life is hard by the yard." I live by this saying, and it's how I will complete this book. At the end of the financial accumulation road, the goal is to have more money than when you started on that road. This is financial planning. I have often said the best financial plan is a stock that goes up. Over the years, we have been able to develop new and interesting ways of implementing Point and Figure analysis. But you know what? Nothing has changed in the basic principles of this method in 140 years. Here's why. The irrefutable law of supply and demand has not changed since first introduced in the caveman days. If you understand and embrace the concept of supply and demand, you are at the right place.

When we first started DWA, we used a Tandy 3000 computer that was considered to be state of the art. We did not have enough money to buy it outright, so we leased it. When it was all totaled, that computer cost $3,000 in rent. That was probably twice the cost of buying it. My guess is today this computer would be in the Smithsonian Institute if it were still around. It performed only a small fraction of the tasks computers perform today. I'm writing this on a computer that cost $400 and has more computer power than the astronauts had when they reached the moon. Twenty years ago, there was no such thing as an online charting system. It was around 1994 when we went live with our Internet-based portfolio management and charting system. We updated 2,500 stock charts by hand for close to a decade. Our relative strength charts were updated by hand once a week. It was a rite of passage for each intern to maintain the relative strength charts each week. Distribution of our research each day was done by fax machine. The machine we used to fax out our 20-page report each day cost $1,800. This fax machine was state-of-the-art technology, and we borrowed it from friends. Since we had no money, only debt in the beginning, we had to go downstairs to another company that magnanimously loaned us the use of their fax. Each day we faxed out our report by hand, page by page. This machine could fax to only one phone number at a time. This was in 1987. I think we paid seven cents a page to use this fax. I can't quite remember the cost. When you start a business with nothing, you do whatever it takes to make it work. By 1994, we were on the Internet; however, our clients were not up on that technology curve yet and still wanted our reports by fax. This is a great example of the "technology gap." Those who wanted to take down stock charts did so through the outdated DOS (disk operating system) system. Today, in 2013, it feels like we are working with *Star Wars* technology. I am continually amazed by what we can teach the computer to accomplish.

I am continually amazed because I am among the few today who can remember the first computer programs written for public use back in the 1960s. People today grow up with technology I did not. Maybe this is why I feel like I'm living in a fantasy world. Today, the iPad 4 was released. Amazing! Remember when you used eight-track tapes in your car to listen to music? Heck, I remember a friend in high school who had a 45 rpm (revolutions per minute) record player in his car, attached to springs to keep it stable. We use to bring stacks of 45 records to play as we drove around in his little Spitfire sports car in Germany where I went to high school. This was technology at its best. How could it get any better than that? Most of you reading this are far too young to remember the in-car record players, but you do remember the CD. People use CDs today, but they are yesterday's technology. What most of you use is iTunes. iTunes allows you to download music from the Internet. I'm not telling you anything new here. I'll bet most of the cars you drive still have the CD sound system. More than likely you kept using the CD for a while before you adapted to music download on the Internet. Most of us will hold on to the old way of doing things until we are forced to switch. It's more comfortable to stick with the old because we're familiar with it. This is the technology gap I keep talking about. I want to keep that concept firmly in your mind because this book will teach you some things that are disruptive to your way of looking at the stock market. We all have preconceived ideas on how the market is supposed to work. Get ready for a ride that will take you "back to the future." Rest assured, technology never sleeps. It keeps advancing, and you too must keep advancing to stay up with it. Examples of the technology gap are everywhere. I remember one of the largest brokerage firms on Wall Street saying the Internet was a "flash in the pan," and they were not putting any significant resources into it. Incidentally, this firm went bankrupt and had to be bought by a major bank in 2009. We knew from the start how important this new technology would be and put all our resources into it. With this new technology, we were able to deliver our product to a much larger population of investors. The Internet did not change what we were already doing—it just facilitated the delivery of it. It was the massive leaps and bounds in computer technology in general that allowed us to push past the boundaries of Point and Figure analysis as it had been known for 100 years prior. We were able to create new and important indicators that stemmed from the basic Point and Figure analysis simply because of the speed of calculations. Productivity is about doing more with less. As computers became more efficient and faster, the Internet allowed us to deliver our product almost instantaneously to anyone, anywhere in the

world. Take, for instance, the speed of calculations today. This speed allows us to compare and contrast on a relative strength basis millions of charts overnight. Think about this for a second. It took us a week to update 200 relative strength charts 25 years ago. Until April 2012, we had the capability of updating millions of charts overnight. Today, we can do the same number in 10 minutes using "cloud technology." We now, almost instantaneously, follow the world. To Dorsey, Wright, the world is open for business. We continue to push the envelope with technology, and every few years we have new and innovative things we have created to help investors and professionals become more successful at the investment process while at the same time we give them their life back. Much of what professional advisers used to do can be done by computer today. This is why I am sure that at some point in the future there will be a need for *Point and Figure Charting,* Fifth Edition. For now, we have more than enough new things to discuss in the fourth edition.

Beginning with the Basics

Let's start with the basics of how this stock evaluation and portfolio management system was developed. The Point and Figure method is not new by any stretch of the imagination. It is, however, a lost art simply because most investment professionals and individual investors have lost sight of the basics that cause fluctuations in the prices of securities. Even though we have been championing this method of analysis for 25 years, we have barely made a dent in the 80 million investors in America. We've only scratched the surface; that's about all, and our business has grown every year for 25 years. We have a lifetime of work ahead of us. In today's rapidly evolving technologies, the irrefutable law of supply and demand remains the same. In the end, the only thing that will outlive technological change, that is truly sustainable, is the transcendent competence of an individual's workmanship. New methods of security analysis continue to crop up, capturing the ever-expanding curiosity of the investment public. It seems everyone is searching for the Holy Grail, and it's been sitting right under their noses. Economics 101 is the way the world works. Schools don't teach it unless you choose, on your own, to take courses in it. In its most simplistic form, the "Irrefutable Law of Supply and Demand" reigns supreme. If there are more buyers than sellers willing to sell, the price must rise. If there are more sellers than buyers willing to buy, the price must

decline. If buying and selling are equal, the price must remain the same. Embrace the simplicity of this because it is all there is. The rest is all fluff designed to make you feel good.

A long time ago, when I was a stockbroker at a major firm on Wall Street, I learned there is no easy ticket to riches. The key to success in this business—and any business for that matter—is confidence. According to my dictionary, confidence means "firm belief or trust; self-reliance; boldness; assurance." In the securities business, the key term in that definition is *self-reliance,* and it is the one trait most investors and stockbrokers lack. Investors today are increasingly averse to making their own decisions, which is why the mutual fund business has grown to record levels. Investors even look to the television to provide them with guidance on where to invest their hard-earned money, not realizing that the business model for TV is advertising, not helping investors. Conversely, there are some investors who take the time to learn how to become more involved in their investments. Most investors look to professionals to guide them when the irony is that 75 percent or more of professional money managers never outperform the broad stock market averages. The typical response from a professional is that they do much more than manage money—they do financial planning, insurance, trusts, wills, and so on. But those are one-time things. Ask them where the real money is made for them and the answer is fees charged for money under management. So let's get real. It appears that looking for professional help has proven ill-fated in many cases. Investors are no further ahead today than they were a decade ago. In the past 12 years, from 2000 to 2012, investors doing modern portfolio theory have earned money market returns, exactly, with much more volatility and much more cost. Investors seeking an adequate retirement have experienced a lost decade. Today, computers have been programmed to handle much of the investment process. In fact, at DWA we have automatically managed portfolios. What is interesting is that although the portfolio construction and management are computerized, the computer only does what we program it to do. So, in essence, the portfolio is constructed and managed exactly as if we had managed it by hand. This computerization of our "rules-based portfolio management system" allows us the ability to handle an infinite number of portfolios. The most important thing the computer does not bring to the equation is emotion. This one word, *emotion,* is responsible for the destruction of assets like no other word in our vocabulary. Most investors look at the stock market as an enigma. It confounds them that the market reacts in what seems to be an illogical pattern. Increased earnings expectations

should result in price appreciation of the underlying stock, right? Not necessarily. In many cases, the opposite happens. In the meltdown of stock prices in 2008, great companies as well as less fundamentally sound companies collapsed. How can that happen if fundamentals drive stock prices? Apparently, they don't. There had to be something else that caused the 2008 meltdown if good stocks and bad stocks went down together. That something else was the imbalance between supply and demand. There simply were more sellers than buyers willing to buy in 2008. In the year 2000, we saw exactly the same thing happen, only the collapse was restricted to technology companies, the very companies the fundamental analysts guaranteed would never go down. At the same time in 2000, those same analysts wrote Apple's death notice. Stocks with questionable fundamentals rose to a price level where the fundamental analyst group had to come up with a new way of valuing companies. This new method of fundamental analysis was called "pro forma." The *Financial Times Lexicon* says this about pro forma earnings: "... the use of pro forma earnings, which are published alongside GAAP (generally accepted accounting principles) numbers, is controversial since it gives companies greater freedom to present their figures in a way they choose, and the figures are not audited. However, investment analysts often assess a company based on its pro forma numbers, giving greater validity to the practice." It was joked about as EEBS: earnings before bad stuff. Then reality began to set in as investors began wondering what in the world TV and Wall Street pundits were talking about. It was a veritable love fest with dot-com stocks. Then without any introduction, the "Invisible Hand of Economics" stepped in and brought sanity back to the markets. All of a sudden, supply began to overtake demand, and companies like Lucent Technologies declined from 80 to the single digits. Major firms on Wall Street were in love with the company at a price of 80. The fundamentals justified the price, but Lucent's only problem was not in the company itself but in its customers' ability to pay for the products they had purchased. Who would have guessed that? Certainly not the three-piece-suited analysts on Wall Street. This information did not show up in the fundamental research until the stock collapsed. It did, however, show up in the Point and Figure chart. Those investors who were well versed in evaluating the supply–and-demand relationship of the stock (Point and Figure chart) saw trouble early on. It is the same reason that on page 100 in *Point and Figure Charting,* Second Edition, I said to sell Worldcom short before it became evident there was trouble with their fundamentals. Fast forward to 2011 and look at the chart of Netflix (Figure 1.1).

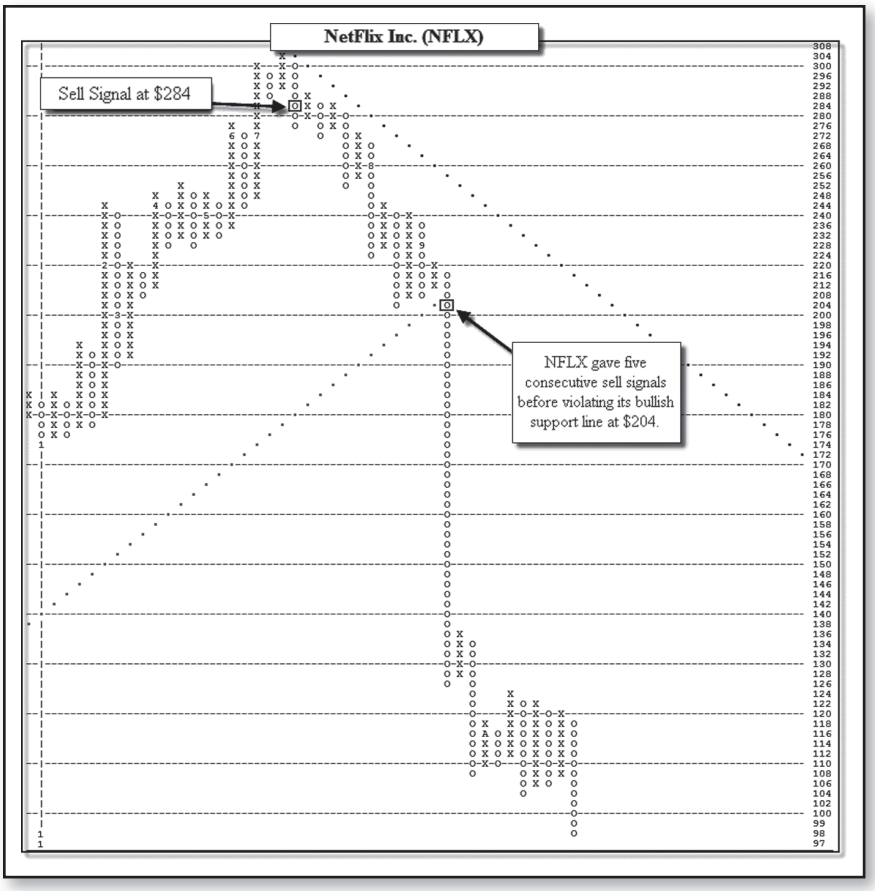


FIGURE 1.1 Netflix

The stock was $304, Wall Street loved it, and everything was coming up roses. Then they made a fatal error in judgment. They raised prices in an economy that was in a recession and, I would say, in many ways in a deflationary environment. People were not willing to accept a price increase no matter how it was presented. The stock collapsed and is trading at $110 after hitting a low of $63. The CEO realized what a mistake it was as their customer base dwindled but it was too late. Supply had already overtaken demand in the stock. The Point and Figure sell signals began at $284 and continued unabated until the stock hit $120. It rebounded four points, then collapsed again. As Yogi Berra once said: "You can observe a lot just by watching." This quote is the epitome of what the Point and Figure method of analysis is all about. You can choose to either watch your stocks on a daily basis or let our computer system do it for you. Over the past 17 years, since

the first edition of this book was published, my confidence in this methodology has increased tremendously. While nothing in the method has changed, how we use it has expanded and grown significantly. We have developed a number of new ways of creating and managing portfolios, using the same relative strength concepts covered in the first edition of this book. We have also found new ways to use old indicators. Often, it's not a matter of creating something new but using the old in new and creative ways. One of the most interesting and useful products that was just coming into existence when the last edition was published was the exchange-traded fund. This class of investment vehicle is growing by leaps and bounds, and I think it is the most important new product to hit the market in my 37-plus years in the business. Hint: learn it well while reading this book.

In the past five years, we have gone through some of the most volatile markets anyone has seen. I don't think 2008 will be forgotten by many investors, and I don't think many of our professional clients will forget that our relative strength work prevented us from owning any equities the whole year. Our Dynamic Asset Level Investing (DALI) platform did not suggest that we own equities for all of 2008. To me this was amazing and a real tribute to what our rules-based portfolio management tools can accomplish. Human emotion is totally taken out of the equation. I think of it as an "operating system" not unlike what a computer must have to operate. Without an operating system, like Windows 7, which I am working with right now, the computer is worthless. Try accessing Google on a computer wiped clean of any operating system. It ain't happening. Now think of investing in the stock market without an operating system in your head, guiding your approach to stock selection and subsequent management of that portfolio. This book provides that operating system. Think of it as Windows Point and Figure 4. The old paradigm of buying quality stocks with real products and visible earnings went right out the window with the crash of 2008. We knew its fallacy for 26 years; it just took 2008 for investors to finally believe us. Those stocks go down, too, without the fundamentals changing before the collapse. In the late 1990s, the mantra on Wall Street was: "Forget earnings, they aren't important, only revenues are important." We heard 22-year-old CEOs suggesting that the old-line companies like Procter & Gamble, the backbone of the United States, "just don't get it." Well, the crash of the dot-com companies clearly demonstrates that the 20-something CEOs were the ones who didn't "get it." Not only that, no one realized until 2008 that all asset classes can become correlated at the same time. Oops, there went modern portfolio theory (MPT). Here is what is confounding. MPT is still

being pushed by brokerage firms simply because they have too much tied up in facilitating the failed strategy. Slowly but surely, investors are coming to realize there is another way and it isn't buy and hope. There is no question that real wealth can be made in the stock market, but this wealth can be wiped out just as quickly as it is made. There is an old market adage that goes like this: "Bear markets return money to its rightful owners."

Attention to the bottom line is now back in vogue as investors recognize that net earnings are, in fact, important—a company has to make a profit or it's out of business. In the latter part of the 1990s, firms attempted to create brand names by simply throwing millions of dollars into advertising. Companies were trying to create solid brand names in one month that took companies like Procter & Gamble 40 years to create. Some companies even sold products below cost, with the expectation of making up the difference in advertising revenues.

This all came to roost in the second quarter of 2000, when the Nasdaq stocks literally melted down in a matter of a few weeks. In 2008, another treacherous year, the margin clerks took over and, in a mad attempt to raise capital anywhere they could, sold anything and everything, totally blowing the concept of diversification. If it could happen once, it can happen again. It was the first experience most investors had with a margin clerk at banks and brokerage houses selling everything they could to raise capital as the banks moved closer to bankruptcy. That old concept of some asset classes being noncorrelated to other asset classes (commodities to equities, for example), providing a cushion in a portfolio when all hell is breaking loose in the market, vanished. The high-flier Priceline.com (PCLN) was as low as $6 in 2000, and is now at $630 in September 2012. Are we back in the dot-com days again? I said three years ago I thought the United States was the next emerging market, and it might just be playing out. The high fliers were not the only ones that were hit in 2000. Some stocks, many New York Stock Exchange names, hit their peaks in 1998. Many of these stocks are just beginning to show signs of life again, 14 years later. It was an interesting market from April 1998 to March 2000, in which the indexes did fairly well while the stocks underlying them were killers. This is very instructive in understanding capitalization versus equal weighting (discussed later in this book). From 2000 to September 2012, the Dow Jones has risen only 14 percent, not including dividends. Here's the problem with guesses advisers use in their algorithms to determine what the market will do going forward. In 2000, brokers were promising investors an 11 percent return each year to retirement. It wasn't that they had a gut feeling their investor clients would

experience those returns. It was MPT, and it's Monte Carlo simulations with mere guesses on input to the computer program. One thing MPT always does is overweight large-cap growth stocks. That was the wrong thing to do in 2000 and in 2012; it's still the wrong thing to do. The preferred overweight in the asset class U.S. equities has been and still is small-cap stocks. You see, we aren't talking about trading here. Since January 2000 the Standard & Poor's (S&P) 500 Large Cap index we all look at as "the market" is down 4.3 percent, while the S&P 600 Small Cap Index is up 131.5 percent, not including dividends or costs to purchase in either one. Which would you have preferred to own since January 1, 2000? Nothing else needed to be done during this period other than own the S&P 600 Small Cap Index. Although the companies that comprise the S&P 600 Small Cap Index are considered small cap, they are billion-dollar companies. This is where it gets real interesting knowing which hand to fold and which hand to hold. That belongs to the chapter on relative strength. Hang on for the ride—it's going to be fun. I'm having fun just writing this, and I know how it ends. I'm like a kid in a candy shop right now. I can't go on without bringing to your attention the fact that during this same period the S&P 500 Equal Weighted Index was up almost 81 percent. That is an 85 percent outperformance on two indexes with the *same* 500 stocks in them. Yes, the same 500 stocks just weighted differently had totally different returns. Would you have liked to have an adviser that could have simply guided you into the S&P 500 Equal Weighted Index (RSP), instead of what everyone thinks is the market, the S&P 500 Capitalization Index (SPX)? I almost want to jump to the relative strength chapter right now. But don't. Push on, slowly but surely.

Finding the Safe Harbor

What do investors have in common with an 18-year-old bungee jumper?

The answer is no fear. During the decade of the 1990s investors came to believe that buying the dips is the key to success: Stocks always come back—don't panic, just buy more. MPT suggests that if you just don't worry, things will be fine in the long run. John Maynard Keynes once said, "In the long run we're all dead." As home prices rose during this period, some people leveraged their homes to put money in the stock market. This kind of situation never ends well, and 2008 was no exception. The meltdown in the market for many was not as bad as the meltdown in the value of their houses. For the first time in many people's lives, they saw real estate prices plummet.

I know it was the first time in my lifetime that this happened. By the end of 2008, a substantial amount of individual investors' wealth had been wiped out. The second I saw this happening early on, when one of our good corporate clients went bankrupt directly due to the AAA subprime mortgage bonds they were selling, I turned to Tammy DeRosier, my chief operating officer at Dorsey, Wright, and said: "We're going back to *Leave It to Beaver* days." In other words, my vision at that moment was that Americans would put themselves under a self-imposed austerity plan that would ultimately increase savings, wipe out credit card debt, and in essence get their fiscal house in order. This is exactly what is happening in Mr. Jones's household. Investors are wondering if there is a safe haven anywhere on the investing landscape. This year dividend stocks have become the rage as the Federal Reserve's artificially low interest rates have forced investors back to stocks that pay relatively good dividends.

The "buy every dip" mentality is what I call false courage. False courage is confidence you may feel when under the influence of alcohol or drugs. It dulls the senses and gives you the confidence to do things you otherwise would not consider. A friend of mine, the late Cornelius Patrick Shea, used to say, "My pappy used to tell me the 'sauce' makes ya say things ya don't mean and believe things that ain't true." The "sauce" for investors consisted of the seemingly never-ending rise in high-flying tech stocks and, prior to 2008, the parabolic rise in real estate prices. It was so intoxicating that investors were "saying things they didn't mean (buy 1,000 more) and believing things that weren't true (revenues are increasing with no end in sight)." This would be the definition of an *investaholic*. Similarly, during the latter part of the 1990s and first quarter of 2000, investors were enamored with the seemingly never-ending ascent of the stock market and in particular the Nasdaq. The media aided this belief with the ceaseless chant of zero inflation and endless increases in worker productivity due to technological advances. Because of their intoxication, investors kept taking more risks through leverage in high-volatility stocks beyond any rational measure. I even had a broker call me with a story of how her aunt was not allowed to use margin at her firm because of her advanced age (she was 80). Do you know what she did? She took a second mortgage out on her house, put the money in her stock account, and continued trading. In essence, she skirted the brokerage firm's margin requirement and margined the account anyway with the money the bank loaned her when she margined her house. I wonder how she fared after the crash of March 2000, May 2000, November 2000, and 2008. She may have lost her house.

The decline in stocks from 2000 to 2002 certainly woke many an investor up to the fact that markets go both ways—up and down. The dot-com crash was confined to technology and was not as widespread as the meltdown of 2008. In 2003 through 2006 the markets lulled investors back to sleep. From July 1998 to present, someone who bought and held the S&P 500 is finding him- or herself with an annualized rate of return of about 1 percent per year. You might first think, "That's not too bad—at least I didn't lose any money." But the fact of the matter is for a great many people that means you have lost, although maybe not in actual dollars. But when adjusted for inflation, you are a loser. When you consider that so many investors were made to believe that they would get 11 percent a year rate of return on equities, dropping to a return of 1 percent a year can really put a dent in your retirement planning. Not only did you not make much headway, you lost a decade. In our short lives, one decade of investing can make the difference between a comfortable retirement and no retirement. Many investors have forgotten that having a logical, organized, well-founded method of investing in the markets is the only way to success. Haphazard, overleveraged, methodless investing will always lead to disaster, just as it has twice since 2000. For example, if an investor loses 50 percent of his portfolio value, that portfolio will have to rise 100 percent to get back up to even. How long will that take at an average 10 percent per year, which is the long-term average going back 80 years? About seven years. If an investor bought at the top in 1973 and rode the market down, it took seven and a half years to get even. Can you wait seven and a half years to get your money back if you ride a bear market down as the media and mutual funds suggest you should do? If your answer is no, then you are ultimately interested in risk management, which is what this book is all about.

I was in a store the other day purchasing a new laptop computer. I got into a conversation about investing in the market with the head of the computer department. He was having a hard time understanding what I did for a living. I have always had a hard time explaining it to those not familiar with Wall Street. I told him that successful investing requires an operating system like the one in every computer. The computer's operating system allows it to effectively read and run software products. Operating systems like Windows 7, which I'm currently using, simply provide a set of instructions that tell the computer how to run. Without an operating system, software cannot run on the computer. Investing is the same. Investors must have an operating system firmly in mind to work from before they can become successful at the investment process.

This operating system is the core belief in some method of analysis an investor both understands thoroughly and embraces wholeheartedly. It's like getting religion on Wall Street. At some point, all successful investors have to find some church on Wall Street that they can attend every week. This is why we titled the motivational book we wrote *Finding Religion among the Rapids* (Dallas, TX: Brown Books, 2004). Many investors subscribe strictly to the fundamental approach of investing. This method only delves into the internal qualities of the underlying company. It does not take into consideration timing entry and exit points in that stock and, above all, supply and demand imbalances. Supply-and-demand imbalances are nothing more than investor sentiment. Other methods of analysis might involve astrology, Fibonacci retracement numbers, Gann angles, waves, cycles, candlestick charts, bar charts, or any other method you are willing to embrace. At DWA, we only subscribe to one irrefutable method—the law of supply and demand. If you want to go back to the basics, with a methodology that has stood the test of time, in bull and bear markets, and one that is easy enough to learn whether you are age 8 or 80, then you are reading the right book. This operating system will carry you through your investment endeavors, from stocks and mutual funds to commodities. Technology advances since the publication of the last edition of this book will allow you to fly by instruments alone. Did you know a pilot today can fly an airliner from takeoff to landing without touching the controls? When you learn what I teach you in this book and become fluent with our web site, you, too, will be able to fly by instruments.

Why Does This Method Make Sense, and Where Did It Originate?

We humans have certain limitations when coping with rapid decision making. Most investors find it difficult to think through the complex decisions they need to make when it comes to investing. The problem is not that we have too much information. The problem is managing and processing this information. It is like a fire hose of information that hits us in the face every day. The question is how to control that massive information flow and break it down into understandable bits that we can use to make effective decisions. In essence, we have decision overload.

The simplest example of how information is organized is telephone numbers. We have an ability to easily remember three or four numbers in

succession, but seven is difficult. This is why our phone numbers are divided up in threes and fours. Similarly, Charles Dow found a way to organize data back in the 1800s. He was the first person to record stock price movement and created a method of analysis called Figuring that eventually led to the Point and Figure method described in this book. The Point and Figure method of recording stock prices is simply another way of organizing data.

At the turn of the twentieth century, some astute investors noticed that many of Dow's chart patterns had a tendency to repeat themselves. Back then, there was no Securities and Exchange Commission; there were few rules and regulations. Stock pools dominated the action, and outsiders were very late to the party. It was basically a closed shop of insiders. The Point and Figure method of charting was developed as a logical, organized way of recording the imbalance between supply and demand. These charts provide the investor with a road map that clearly depicts that battle between supply and demand. It allowed the outsider to become an insider.

Everyone is familiar with using maps to plan road trips. When we drive from Virginia to New York, we start the trip on I-95 North. If we don't pay attention to our navigating and inadvertently get on I-95 South, we are likely to end up in Key West, Florida. To prepare for a journey with your family to New York from Virginia, you need to familiarize yourself with the map, check the air in your car's tires, begin with a full tank of gas, and make sure the children have some books and toys. In other words, plan your trip. Most investors never plan their investment trip. The Point and Figure method of analyzing supply and demand can provide that plan. Nothing guarantees success, but the probability of success is much higher when all the possible odds are stacked in the investors' favor. Somewhere along the road, you may be forced to take a detour, but that's okay as long as you stick to your original plan. This book outlines the best plan for financial success when you are investing in securities.

When all is said and done, if there are more buyers in a particular security than there are sellers willing to sell, the price will rise. Conversely, if there are more sellers in a particular security than there are buyers willing to buy, the price will decline. If buying and selling are equal, the price will remain the same. This is the irrefutable law of supply and demand. The same reasons that cause price fluctuations in produce such as potatoes, corn, and asparagus cause price fluctuations in securities.

Two methods of analysis are used in security evaluation. One method is fundamental analysis. This is the method of analysis familiar to most

investors and the only method taught in universities. It deals with the quality of the company's earnings, product acceptance, and management. Fundamental analysis answers the question: what security should I buy? Technical analysis is the other basic method. It answers the question: when should I buy that security? Timing the commitment is the crucial step. Fundamental information on companies can be obtained from numerous sources. There are many free Internet sites that deal strictly with fundamental analysis. The technical side of the equation is much more difficult to find because few securities professionals are doing quality technical analysis that the average investor can understand. This book is designed to teach you how to formulate your own operating system using the Point and Figure method. The fundamental side of the equation can be satisfied with an inexpensive subscription to Value Line or Standard & Poor's or many free places on the Internet.

Why You Should Use Point and Figure Charts

Although the investment industry is overloaded with different methodologies to evaluate security price movement, the Point and Figure method is the only one I have found to be straightforward and easy to understand, that lends itself to portfolio management, not just trading back and forth. I want you to understand now that once you have a grasp of how this method works, the computer will do the work for you and can even deliver the answers to your mobile device. The charts are made up of X's and O's. Recording the movement of a security using this method is very much like recording a tennis match. A tennis match can last 12 sets. Each player can win a certain number of sets, but the final count determines which player wins the match. In the Point and Figure method, we are interested only in the culmination of the match, not the winner of the underlying sets. The patterns this method produces are simple and easy to recognize—so simple that I have taught this method to grade-schoolers in Virginia. I have always maintained that simple is best.

The concept underlying any method of analysis you choose must be valid. Supply and demand is as valid and basic as it gets. I am not criticizing the validity of other methods; it's just that most people can easily understand supply and demand because it is a part of everyday life. Why not make it a part of your everyday investing?

In the United States today most investors are concerned about retirement. The Baby Boomers are nearing retirement age. This group will reign supreme for at least another decade. The trading mentality has been long gone; wealth accumulation is all there is now. In every Boomer's mind today is how much money will there be at the end of the employment road. I talked to one gentleman at the pool hall where I hang out (Diamond Billiards, Richmond, Virginia) the other night and he had $70,000 saved for retirement. He was, I would guess, 58. He asked me what he should do for retirement. I thought about it and said I would bring him an income-producing portfolio he could hold. He should have been asking that question when he was 25, but what 20-something ever thinks the end will ever come? It saddens me that it is not a required course to take in high school, much less college. This is why the vast majority of Americans are investing illiterate. The only thing one can do at 58 is to try to have a logical, organized approach to investing for the next 7 years. I can tell you, 65 comes fast.

Over the past quarter century, we have refined the Point and Figure method and adapted it to the process of financial planning and wealth accumulation. But no matter how we refine it, the basic philosophy is still intact. Once you learn these basic principles, your investing confidence will increase tremendously. You will soon find yourself acting rather than reacting to different market conditions. This method changed my life, and it can do the same for anyone who takes the time to read this book and then implement the investing principles contained herein.

In the Beginning

It took me years of operating in a fog in the brokerage business before I came across the Point and Figure method. I started my career at a large brokerage firm in Richmond, Virginia, in late 1974. When training new brokers, the firm focused primarily on sales. As trainees, we were drilled in the philosophy that the firm would provide the ideas and our responsibility was to sell them. We were in essence intermediaries doing the exact same work a computer does today. The first four months at the firm were devoted to study. Every potential broker must pass the Series 7 examination to become registered with the New York Stock Exchange. The course was extensive—covering everything from exchange rules and regulations to complicated option strategies. Once we had passed the exam and completed five weeks of sales training, we were ready to be unleashed on the public. I think back

37 years now and realize how unprepared I was to handle investors' hard-earned money. In fact, I came to work totally unprepared to do anything but pass on my firm's research. Back then, most of my clients had defined benefit plans at their company. All they had to do was work for 30 years and they got the retirement pot of gold. They were really interested in trading because retirement was already taken care of. Today, it's different. Back then, I was often asked, "What's hot, what's not?" We brokers always had a group of stocks we used for trading. Today it's totally opposite. Although it's fun to trade stocks, the real focus is on retirement. Advisers today must operate under the fiduciary rules and regulations. They must do what is best for the customer. My guess is before the year 2013 is over, regulations on how advisers handle investors' accounts will become even more stringent. These onerous rules are not necessarily good for the client, either. The more regulation the adviser must operate under, the less advising he will be doing. "For every action there is an equal and opposite reaction."

As in any other profession, experience counts a lot, and we were severely lacking in that area. The market had just gone through what seemed to be a depression, losing about 70 percent of its value. Prospecting for new accounts was a difficult task at best, but those of us who survived spent the next four years building a book of business and learning by trial and error. Each morning, we had mounds of new recommendations from New York to sift through, all fundamental. We were not allowed to recommend any stocks our firm did not have a favorable opinion on; the rule was: no thinking on our own—it could cause a lawsuit. Our job was to sell the research, not question it. Can you imagine how ill served the investors were?

Over the years, we had some tremendous successes and some spectacular failures, definitely not a confidence builder. In my spare time, I kept searching for some infallible newsletter writer. This search, however, only proved that the newsletter writers were better at selling newsletters than at picking stocks. The ship was basically rudderless, but somehow we forged ahead. Now, almost 38 years later, the landscape has changed significantly. The brokerage business still focuses on MPT, and this is primarily delivered by computer. The broker asks some questions and gains a feeling for the investors' risk tolerances. They then key into a computer, say, moderate risk level, and the computer spits out a Strategic Asset Allocation Pie created by all kinds of assumptions on future interest rates, future market volatility, future returns on baskets of stocks, and so on. You get it—future this, future that, assumption this, assumption that, use a Monte Carlo simulation, spin the wheel lots of times and voila, your strategic pie.

Guess what? In the year 2000 these simulations suggested to investors that their portfolios would grow at an 11 percent rate for the next 20 years. How'd that work for you? Well, the market caved in after the dot-com bubble burst, 9/11 happened, and in 2008 the whole market melted down, all asset classes together. Those computerized guesses did not work. In fact, Mr. Jones has less money today than he had then when he was virtually guaranteed an 11 percent annualized return. The computer makes recommendations on what funds to have in the pie and the pie is then rebalanced (good things sold and bad things bought) twice a year. So, in this strategic allocation program, the account is rebalanced twice a year or so. Rebalance is a great buzzword that no one understands. It means that the good things in a portfolio will be sold so you can buy the bad things in the portfolio. The assumption is that the bad stuff will ultimately turn good if you wait long enough, and the good stuff will turn bad over time. Doesn't work and doesn't make sense, but they still do it today even after the MPT had been totally discredited. As Paul Harvey, the great radio announcer, used to say, "And now you know the rest of the story." We offer just that—the other side of the story.

During my tenure as a stockbroker at that firm, I specialized in option strategies. Options were relatively new, having been first listed for trading in April 1973 on the Chicago Board Options Exchange. I spent much of my time studying this investment tool, and in 1978 I was offered the opportunity to develop and manage an options strategy department at a large regional brokerage firm home-based in the same town: Wheat First Securities, now Wells Fargo. It was an irresistible challenge, so I embarked on this new adventure, and an adventure it was.

Overnight, my clientele changed from individual investors to professional stockbrokers. I was now responsible for developing a department that would provide options strategy ideas to a sales force of 500 brokers. At this moment, I had to be totally honest with myself. Just how much did I really know about the stock market? I knew that my success at selecting the right stocks to support our options strategies would ultimately determine the success or failure of my department. The answer to that question was startling.

After almost five years of working as a stockbroker, I had very little knowledge about selecting stocks on my own, much less evaluating sectors and the market itself. I did what the firm directed me to do. The one thing I did know was that relying on any firm's research was likely to be hit or miss. If I was to succeed I would have to be self-contained with respect to the

research that came out of my department. Developing a successful options strategy department meant I would have to find someone who was adept at stock selection.

During my search for a "stock picker," one name continued to crop up: Steve Kane, a broker in our Charlotte branch. I contacted Steve and explained my new adventure to him and offered him a position in my department. He decided to join me. My grand plan was that Steve would provide the stock, sector, and market direction, and I would provide the option strategies to dovetail his work.

As any craftsman would, Steve brought along his tools, which consisted of a chart book full of X's and O's on hundreds of stocks and a Point and Figure technical analysis book written by A. W. Cohen (this book is no longer in print). The basic principles of the Point and Figure method were developed by Charles Dow, the first editor of the *Wall Street Journal.* Later, a book was first published on the subject in 1947, the year I was born, called *Stock Market Timing.* Each week, Steve would fastidiously update these charts of X's and O's and use these charts to make his stock selections. Over the first year, Steve did very well. Stocks he selected to rise generally did. Stocks he felt would decline generally did. His calls on the market and sectors were also very good. The team was working well and, best of all, we were self-contained. We were a technical analysis and options strategy department rolled into one. We weren't always right, but we were more right than wrong and, most important, we had a plan of attack.

Just as things were looking good, a specialist firm on the New York Stock Exchange offered Steve a job with the opportunity to trade their excess capital. It was an offer Steve could not refuse, and I supported his decision to go. I found myself back in the same predicament that I had been in a year earlier. Rather than try to find someone else who understood the Point and Figure method of technical analysis that I had become accustomed to, I decided it was time to learn it myself.

Steve explained the basics to me and recommended I read his closely guarded copy of A. W. Cohen's book. That weekend I started reading it, and after reading the first three pages, my life changed. All the years of operating in a fog, searching for answers, and believing it was all too complicated to learn, came to an end. What I found in the first three pages made all the sense in the world to me. I knew in that moment what I would do for the rest of my life. This was the missing link that all brokers needed to effectively service their clients. I knew my job from that day forward was to teach this method to my brothers and sisters in this business. We now

operate the only Investment Advisor Institute in the United States, and it is the culmination of my dream that night. We hold two to three a year and do many webinars to teach this method each month to both individual investors and professionals. We have trained thousands of stockbrokers in this method and watched their confidence and client profits climb. We have also held our first Individual Investor Institute in concert with Virginia Commonwealth University, and the auditorium was packed. Something right is going on here.

If you think into the future, it's all going to the phone. Think mobile. You will eventually reach into your pocket for your phone and manage all your investments from there. You will enter orders from your phone, you will be alerted to changes in your portfolio on your phone, and you will own automatically managed portfolios. How do I know this? We already do it. At Dorsey, Wright we already operate in the future. In the end, this book is about implementation of the strategy, and technology does the rest.

On Taking Risks in Life*

There are many similarities between the principles in sports and the psychology of the stock market. I am a former world record holder in powerlifting, and in my endeavors to improve my lifts, I learned a lot from Judd Biasiotto's motivational articles in *Powerlifting* magazine. I have gotten to know Judd personally, and we see so many similarities between our two businesses that we have written articles together. In fact, we published two books together in concert with my analysts at DWA. The books are entitled *Keep Pedaling, Zen Farmer* (Dallas, TX: Brown Books, 2004) and *Finding Religion among the Rapids* (Dallas, TX: Brown Books, 2004). These books explain how some of the psychological aspects of sports competition can be applied to investing. I think this story Judd tells about taking risks really hits at the heart of investing—it is just an exercise in continual risk management.

When Judd was working with the Kansas City Royals baseball team, his roommate, Branch B. Rickey III, met a guy who was willing to let us buy into a condominium project being constructed in Florida. The deal was that we could purchase up to 10 condominiums at a price of $10,000 each. At the time, $10,000 was a pretty good chunk of money, but the deal was

*This section was written with the assistance of Judd Biasiotto, PhD.

extraordinary. If everything went as planned, there was a good chance we could double or triple our money in no time. Still, there was a risk—there always is a risk. Because it was beachfront property, the taxes were very high. Unlike Branch, I did not have the money to invest long term. I would have to borrow the money at a fairly high interest rate and then hope that I could turn the property over in a short period. Otherwise, I would lose a lot of money. In the end, I decided not to do the deal. Of course, you know the end of the story already. The property is now worth anywhere from $500,000 to $1 million.

> Yes, I could have been living in the Bahamas relaxing on the beach, but I failed to take the risk. There is one thing I'm certain of—if you don't have the guts to put yourself on the line now and then, your chances of success are limited. To reach the top, athletes—or anyone else for that matter—have to know how to live on the edge. They have to enjoy the elements of risk and a little danger. I'm not talking about taking needless, senseless, incalculable risks, like running with the bulls in Pamplona or attempting a 500-pound dead-lift when your personal best is 300; such actions prove nothing except that you have the brain of an infant. What I'm talking about is intelligent, calculated risk-taking in which the risk in question has a legitimate cost-reward relationship.

Judd's comments really speak to the business of investing. You have to be a risk taker to even survive in this business, much less flourish. Every time you buy a stock, you are risking your hard-earned money. If you are a broker, you are risking your clients' hard-earned money. If you can't operate in a high-risk environment, then the business of investing is not for you. I have met many investors and brokers who just couldn't make a buy decision for fear of losing their own or their clients' money. It's good to have a healthy dose of trepidation in this business of investing money. That way, you don't make stupid mistakes, but freezing only causes you to miss great opportunities. There is a big difference between having a healthy respect for risk and allowing risk to paralyze your thought processes. Many investors and brokers simply can't deal with market volatility. A fine line exists between managing risk and being controlled by risk. The stock market is not a place for the faint of heart. To reach the pinnacle in the personal or professional investment field, you have to learn to live on the edge, to enjoy the element of risk and danger—at least to a reasonable degree.

Look back through time and you'll find that people who had the courage to take a chance, who faced their fears head on, were those who shaped history. The people who played it safe, who were afraid to take a risk, well, have you ever heard of them? I love what Theodore Roosevelt said about this very issue. Here is an excerpt from the speech "Citizenship in a Republic" delivered at the Sorbonne, in Paris, France, on April 23, 1910:

> It is not the critic who counts, not the man who points out how the strong man stumbles or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood, who strives valiantly, who errs and comes up short again and again because there is no effort without error and shortcomings, who knows the great devotion, who spends himself in a worthy cause, who at the best knows in the end the high achievement of triumph and who at worst, if he fails while daring greatly, knows his place shall never be with those timid and cold souls who know neither victory nor defeat.

Roosevelt's words remind me of this business of investing and how many critics are out there ready to pounce on your every misstep although they never step into the ring; they never actually put their reputation or their money on the line. In the case of a professional, these critics never lose one minute of sleep because they are worried about other people's well-being.

Do you see yourself in the preceding quote? Those of you who are reading this book are the people in the ring. You are here to learn this method to better help you fight the battle. You realize that nothing is perfect, and at times you will err and err again; but quit, you will never do. As time goes on, you will begin to intuitively understand things in the market that used to baffle you. Eventually, you will reach craftsman status. The critics will continue criticizing because that is what they do best. Just turn the television on to any financial station and you will come away with gibberish. I often call these TV stations Public Enemy number 1. Once you nail down these principles of analysis, you will have no need for business periodicals or financial TV.

I remember vividly my broker years. My face was marred and bloodied many times, but I was in the ring trying, striving for excellence. I just didn't have a plan back then. What a difference this information and way of thinking would have made if they had been available to me when I was a broker. Mix this with my enthusiasm and dedication to excellence, and the

combination is unbeatable. Many of you have already done this, and it makes me feel so good to see so many of you actually making a major difference in your own and others financial well-being.

Theodore Roosevelt was right: the credit goes to you, the investor or broker who is actually in the arena, who at times comes up short again and again but in the end experiences triumph. This is why I wholeheartedly recommend you learn these methods and manage your money yourself or work with an adviser who adheres to the principles. Win or lose, be the one in the ring where the action is. Make the decisions; take the calculated risk; live. Don't find yourself at the mercy of others or at the end of your career having ridden the bus and looked out the window, watching others reach greatness. It's all here for the taking. You just have to want it. Sports are full of great physical specimens, but there is a real shortage of athletes who are willing to play their game with reckless abandon, and athletes who are willing to put themselves and their careers on the line. Those who do are usually the ones at the top.

The truth in that last line inspires me. If you're not willing to risk, you have no growth, no change, and no freedom. And when that happens, you are no longer involved in living; for all practical purposes, you have no life. You're dead, but you just don't know it. So risk, for goodness' sake. Be a part of life. You have the power to be or do anything you want. You can produce miracles if you have a mind to. You have the magic; you just have to tap into it. Get in touch with it, make things happen, live—journey to the stars, push on to new galaxies. If you don't, you will never know your greatness!

CHAPTER 2

Point and Figure Fundamentals

Here we are on the fourth edition of this book; it could be the 400th edition and this chapter would remain the same. It has not changed for over 150 years. Many investors are familiar with charts of some kind or other, whether from school or reading newspapers or magazines. Point and Figure charts were developed over 100 years ago and have stood the test of time. We've even added a new dimension to the history of their effectiveness in negotiating all markets. That new dimension is the Internet, and now the advent of iPads and iPhones changes the touch and feel we were used to on computers. The Internet has allowed us to deliver our charting system to anyone in the world who has access to the Internet. The major leaps in computer technology have allowed us to create some amazing indicators that only 10 years ago were not possible. Until recently, we updated millions of charts overnight. Today, we can do the same charts in 10 minutes using cloud computing. We have been able to create the most interesting institutional products because of this speed. Although we have technology that allows us to operate at the speed of light, we still do the same things we did 30 years ago, by hand. In a way, everything has changed; then again, nothing has changed. When I say Point and Figure charting has withstood the test of time, I mean right up through today in the year 2013. Each year, I look back and find that my confidence in what we do only increases. Remember the word *confidence.* It's the key to success in everything you do.

I have taught this method of technical analysis in many seminars and classes. I have even taught it to schoolchildren as young as 12 years old.

One reason this methodology is so teachable is that it is based on supply and demand. The irrefutable law of supply and demand governs the movement of prices in stock, or anything else for that matter. If there are more buyers than sellers willing to sell, prices rise; conversely, when there are more sellers than buyers willing to buy, prices decline. These imbalances in supply and demand—and nothing else—cause prices of stocks to move up and down. When you cut through all the red tape and obfuscation on Wall Street, you are left with the raw facts of supply and demand. Fundamental changes in the underlying company's outlook can cause this imbalance, but nevertheless it is the imbalance that causes the stock to move. Don't get me wrong. I am not saying fundamental analysis is not important: It is the first line of defense. I want any stock I buy to be fundamentally sound. I love to start with a list of fundamentally sound stocks before I begin to evaluate the supply-and-demand relationship of the stocks. All that is needed if you want to have such a list is a subscription to Value Line or Standard & Poor's newsletters. Keep that firmly in mind as we go forward. The problem with fundamentals is they change ever so slightly early on, and this change is rarely picked up on the fundamental analyst's radar screen. This is why in 2008 fundamentally sound stocks melted down with the rest of the stocks. If fundamentals caused price change, then those stocks that were fundamentally sound would have held up, but they didn't. The investors who truly understand these fundamental nuances begin to cast their vote on the stock early on, and this causes the supply-and-demand relationship to change. This change is then picked up on a Point and Figure chart, which in turn tips off the astute investor, who understands this way of charting, of an imminent change in the underlying stock's direction. All too often, fundamental analysts say they missed the decline in the stock because the businesses of the companies they followed were not failing. Until the underlying business begins to change, they cannot change their opinion, and rightfully so. Their expertise is evaluating the fundamentals of the underlying stock, not its supply-and-demand relationship. Take, for instance, Caterpillar Tractor. Through most of 2012 the stock was a dismal performer, topping out at $116 and bottoming out at $79. That is a 32 percent hit in this stock while the SPX has risen 12 percent at this writing. But look at the chart of CAT (Figure 2.1). It is now $89 and has just broken the long-term downtrend line. It is suggesting that for whatever the reason the stock has become controlled by demand. Naturally, I want to buy on a pullback to support, and that ideal position would be initiated at around $85. An investor might

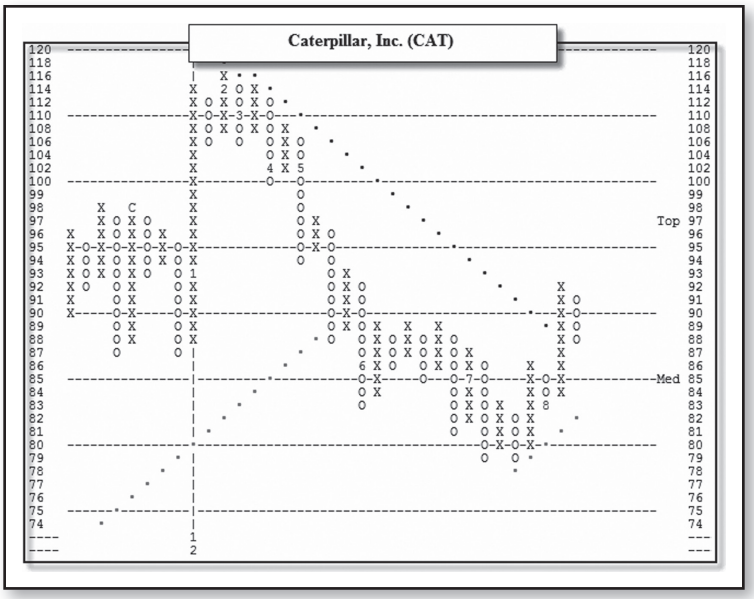


FIGURE 2.1 Fundamentals of Point and Figure: Caterpillar, Inc.

even consider averaging in the position. Get some now and average in if the stock goes up or down. It is interesting to note that a firm that follows CAT on a fundamental basis recommended a buy on the stock April 16, 2012. The stock dropped 22 percent. They kept that rating until July 18, 2012, and they then took the buy off and replaced its recommendation to Neutral. Going from buy to neutral is perceived on Wall Street as sell. The stock is up 6.5 percent to date, August 14, 2012. Interesting how that works. I surmise this company will reinstate the buy on the stock when it is up 30 percent from here. Go to www.yahoofinance.com and search the stock. You can see all the fundamental recommendations on stocks there. Google finance will do the same.

The market looks ahead, which is why watching the financial TV shows and reading the financial papers is, in general, a total waste of time.

The Point and Figure method of analyzing stock movement was designed simply as a logical, organized way of recording this battle between supply and demand. The word *organized* is the key. A basic road atlas would be difficult to use if the actual lines depicting the roads and interstates were missing. It is the same in the stock market business. Looking at an endless list of high-low-close quotations on any particular stock can be equally confusing. When these quotations are organized in a logical fashion, however, the battle between supply and demand becomes much more evident. The Point and

Figure chart simply shows whether supply or demand is winning the battle. We use various chart patterns and trend lines to guide our buy and sell decisions. These patterns are covered in detail in later chapters, as is market and sector analysis.

A tennis match is a helpful analogy in describing this battle between supply and demand. Consider a match between tennis greats Jimmy Connors and John McEnroe (both old-timers now but two of the all-time greats).

Let's call demand Jimmy Connors and supply John McEnroe. Their tennis match consists of various sets. The sets in this tennis match are similar to the Point and Figure chart moving back and forth, changing columns of alternating X's and O's. This seemingly random movement in the Point and Figure chart is similar to the seemingly random changes in sets the players win during the tennis match. Eventually, Connors or McEnroe wins enough sets to emerge victorious in the match. Likewise, only when the match between supply and demand is completed can we get a handle on which way the stock is likely to move. The Point and Figure chart considers the sets that are played as market noise and not worthy of inclusion in the decision-making process. In the short run, stock prices move about randomly, but eventually demand or supply takes control and a trend begins. In this book, I refer to tennis and football in explaining many of the market indicators and stock chart patterns you are about to learn. Let's play ball!

Basic Tenets of a Point and Figure Chart

We begin with the basics of maintaining your own chart. We use plotting a stock as our basis for explaining how to chart, and from this you will be able to plot mutual funds and commodities as well. The concept is the same for anything that trades. This is why it is easy to be as well versed in the Indonesian stock market as it is in the U.S. stock market. It's all about price change and nothing else. It takes only a few minutes each day to update 20 or 30 charts by hand, but why bother when we have a web site that does all the work for you on virtually everything that trades on a global basis. It does help in gaining a strong feeling for the process if you maintain a few by hand each day. We have a broker client who updates over 400 each day by hand and would never give up that process no matter what. Most investors, however, don't have that time available after market hours, and thus the Internet is a valuable time saver. If you

should choose to maintain charts by hand, all you would need is a financial page providing the high and low prices of stocks each day. If you have Internet access, you will be in technical analysis heaven these days. You can even ask our system to search for stocks with the technical attributes you desire, and in a matter of a second, you will get the answer in a list of stocks that qualify. From this list you could easily dump those names into a matrix, and the system would in effect create a massive "arm-wrestling contest" comparing each stock's relative strength to each other in the portfolio and list them from best to worst. This is technology we did not have when I wrote the third edition of this book. This is the technology that will allow you to manage your investments on your smartphone. However, before you use this technology, it is essential to gain a strong understanding of exactly how this portfolio management system works. It's the same reason you must obtain a driver's license before you can legally drive a car. Look at this book as your study guide for your portfolio management driver's license. Half measures will yield you nothing, so read the book slowly and carefully and you will be set for life. Let's get into the construction of the chart.

The Point and Figure chart uses only the price action of the stock—volume is not a consideration. Volume will have to show up in the chart patterns because there will be no movement of the stock unless there are more buyers than sellers willing to sell or more sellers than buyers willing to buy. Much of the volume in stocks today is related to option strategies and hedge fund activities that have nothing to do with a bet on the direction of the stock. You would be amazed at how much volume is just option related. Remember, we are interested only in the battle between supply and demand. Two letters of the alphabet are used in this method of charting, "X" and "O." The X represents demand. The O represents supply. The key to this method is how the chart moves from one column to the next. For the purposes of this book, we will use the three-box reversal method. As you become more adept, you may want to choose other reversal points. At my company, however, we never deviate from the three-box method described in this section: we keep it simple. Figure 2.2 shows a basic chart that gives you an idea of what the Point and Figure chart looks like.

The chart pattern is formed by alternating columns of X's and O's. The only way a column of X's can change to a column of O's is by reversing three boxes. The same three-box reversal method applies to the column of O's. This moving back and forth from one column to the next

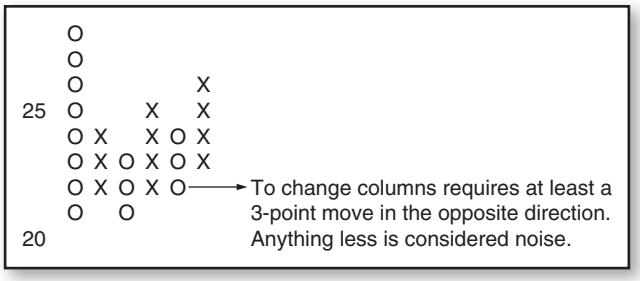


FIGURE 2.2 Basic Point and Figure Chart

is what causes the chart pattern to form. This is where the Point and Figure chart drastically departs from the method of the bar chart. The Point and Figure chart leaves volatility out of the equation and gives you a clear picture of the battle between supply and demand. The bar chart, however, includes volatility in the equation because the chart must be updated every day no matter how inconsequential the move might be. This is why bar charts are subjective and difficult to read and are rarely effective for many people who use them, especially within the confines of managing a portfolio of stocks.

Let's get into the mechanics of charting by looking at the values of the boxes we primarily use in constructing the chart. When I say box sizes, I mean the boxes on a simple sheet of chart paper. You know the paper—the same charting paper you used to get in biology class in high school. The box sizes change as the stock price moves through certain levels. This is why we call this method a three-box reversal method rather than a three-point reversal method. It is important to think in terms of boxes rather than prices. Simply stated, when a stock is between 0 and 5, the box size on the chart is ¼ of a point. Between 5 and 20, the box size moves up to ½ point per box. Between 20 and 100, the box size is 1 point per box. Above 100, the box size rises to 2 points per box. Finally, above 200, the box size is 4 points per box. Keep the following table handy while you are learning to chart.

Price ($)	Box Size
0 to 5	¼ point per box
5 to 20	½ point per box
20 to 100	1 point per box
100 to 200	2 points per box
Above 200	4 points per box

The Internet age ushered in higher-priced stocks and, more important, more volatility. It was a period not unlike the Roaring 20s. It was our Roaring 20s. I look back on that period as a Wild, Wild West adventure. Fundamental analysts had no idea how to value these stocks they had never seen before. It was an intoxicating period where dentists and doctors were giving up their practices to day trade. Most investors confused a bull market with brains. When the bust came, only the technicians saw it coming, for all we watch is supply and demand. After the Internet bust, energy stocks and metals stocks became the high fliers. Then with the meltdown in 2008, these stocks became low fliers. Everything was turned upside down. What were for decades considered noncorrelated assets became correlated in 2008. Modern portfolio theory (MPT), already discredited by losing money for investors for the previous 10 years, was finally put to rest. Housing prices fell, and this was something everyone considered the rock-solid investment that would help them in retirement. Those youngsters who were too young to feel the sting of the dot-com crash experienced the 2008 meltdown. They won't forget this one for the rest of their lives. The market still has not come back. Yes, it had a nice rally in 2009, but 50 percent of the trading volume is gone and it's now August 2013. Investors have given up; they have nowhere to turn. Relative to the large number of advisers in the United States, there are few craftsmen who understand what you are now reading. They have given up and are now buying 10-year treasuries, knowing that after inflation they are losing money, but they still do it. Here's why. The largest group of investors is Baby Boomers. I'm one of them. They are coming to the realization that they are now living in the back nine holes of their life. They near retirement, sit down with their spouse, add up all their resources, and one looks at the other and says, "Honey, that's all there is." And since they have taken care of their body and health care continues to get better, they might live to 95. Then what? So, hell yes, they are scared, and since they have lost all faith in Wall Street, they choose the safest place they can find. They subscribe to what Will Rogers once said, "It's not the return on my money I'm concerned with, it's the return of my money." That's why volume on the New York Stock Exchange has dried up 50 percent since its high in 2008.

So stocks go up and go down. When the volatility is high, one of the best ways to adjust for that volatility is to increase the box size. Many stocks in the technology and Internet craze were so volatile that we had to increase the box size enough to compress the chart to obtain a normal picture of the supply-and-demand relationship of the stock. In fact, stocks

like Yahoo! in 1998 to 2000 often required 10 points per box to compress, or slow the chart down so we could see a normal picture. What you get by increasing the box size of a highly volatile stock is a perfect picture of the supply-and-demand relationship of that stock, but—and this is a big but—the stop-loss points become so painful it is out of reach for most every investor. And these Internet, high-tech/high-wreck stocks absolutely wiped out many investors in 2000. In 2000, reporters suggested it was all but over for this little company called Apple Computer. Since then, it hit $600, and Google hit $620. Think about this for a second. If we have to increase the box size from, let's say, 1 to 5 to slow the chart down enough to get a good picture of supply and demand, this stock is too volatile for most investors. Many investors saw stocks drop 50 percent or more in a single second in 2000. Apple Computer, for example, reported less-than-expected earnings for a quarter. Wham! The stock was down 50 percent on the opening. This is important: As you embark on your investment endeavors, remember that stocks with 5-point box sizes are out of the realm of most investors' risk tolerance. If you find it compelling to invest in these stocks, buy 10 shares. This will help you slay that monster called volatility. Here is an interesting situation I found myself in, in 2011. Baidu, Inc. is the Chinese counterpart to Google. It is what one would call a high-volatility stock. I have to admit that sometimes I have a propensity to pull the slot machine lever. Baidu was in the $300s at the time. I would buy 1,000 shares on margin. That is $150,000 investment. My plan was to catch the stock at the right time, get a bounce immediately, and set a stop at entry point, then ride the stock into the sunset while it rose another 100 points. In most cases on Wall Street when you overleverage a position your plan goes right out the window. Joe Louis once said, "Every fighter has a plan until they get hit." It's the same in investing. I have seen many people tell me how well they trade using a play account. The fun stops when the account is populated with money. Then the real punches are thrown. My plan was great on paper. But every time I tried to overleverage and catch a trend, it went the other way. With a massive position like that, it doesn't take much movement the wrong way before the pain gets too uncomfortable to bear. You undoubtedly cover the position at a loss only to see it do exactly what you expected it to do. The first punch was thrown and the plan went out the window. So one day I decided to prove a point. I would only take a 10-share position in Baidu and forget it. With only 10 shares there is no emotion. What happened is I ended up making about 80 points on the trade. In fact, it became an investment, not a trade.

This proves rule number 1 of investing: never overleverage a position. If you generally buy 100 shares, do not buy 1,000 even if you can afford it. Remember this old market adage: "Sell down to your sleeping level." Always know what your sleeping level is.

On our web site, we have a system called "Smart Charts." These charts give the user the ability to raise or lower the box size on any chart. This can give the chart user some perspective when making a buy or sell decision on that stock. Often, we will gravitate to a smaller box size on a stock to help in establishing a less painful stop-loss point. We have come a long way on our web site (www.dorseywright.com) since its debut in 1994 when we were one of the first to use the Internet as a delivery system. We have now been on the Internet for 19 years.

Let's go over these different box size values once again. I want this to be set firmly in your mind. If a stock was trading below 5, then each box would have a value of ¼ point. Between 5 and 20, the box size would be ½ point. Between 20 and 100 (where most stocks trade), the box size would be 1 point. If the stock was trading at 100 or higher, the box size would be 2 points; and above 200, the box size would be 4 points. Again, these are the standards or the "default" box sizes. The beauty of the system is that you have control of what you want the box size to be. Some stocks are high dividend payers and have very low volatility. The standard box sizes might not be right for these stocks and thus require a smaller box size. As I mentioned, you can make changes on our system. The key to making the chart relates to how the chart switches from one column to another. When a stock is rising and demand is in control, the chart will be in X's. Conversely, when a stock is declining and supply is in control, the chart will be in O's. It requires a three-box reversal or more to be significant enough to warrant changing columns. Therefore, to change columns from X's to O's when the stock was between 20 and 100 would require 3 points. We established that between 20 and 100 the box size was 1, so three boxes equals 3. The same three-box reversal would only be 1½ points if the stock were between 5 and 20. If the stock were trading below 5, the same three-box reversal would only be ¾ of a point because the box size in a stock between 0 and 5 is ¼ of a point. Think in terms of box reversals.

Figure 2.2 illustrates how much the stock must rise or fall to create a reversal on the chart. In this chart, each column has at least three X's or three O's, maybe more, but never less. Although I am being redundant, that's okay—I intend to be redundant in this chapter to help you catch on to the basics of maintaining your own chart. The rest of the book will flow

easily once you understand this concept. If you don't catch on after the first reading, go back and reread this chapter again and again until you are comfortable with the concepts. Believe me, it will be worth your time. When you become a craftsman at this easy method, you will join an elite group of investors and professionals who consistently make money and manage risk in their portfolios. I call them The SEAL Team of Wall Street. Another note I want to reiterate is, once you understand how to chart a stock, the same applies to a mutual fund. Just think about how you will be able to take total control of your 401(k) with this method of portfolio management.

Updating a Point and Figure Chart

When I lecture on this subject, I use the flowchart shown in Figure 2.3 to demonstrate how to update a chart. The basic concept is as follows: whichever column the chart is in, you will remain in that column as long as the stock continues in that direction by one box or more. Let's stop and think about that statement for a second: "As long as the stock continues in that direction by one box or more." So, if the chart were in a column of O's and declining, your first question of the flowchart at the close of the business day would be, "Did the stock decline one

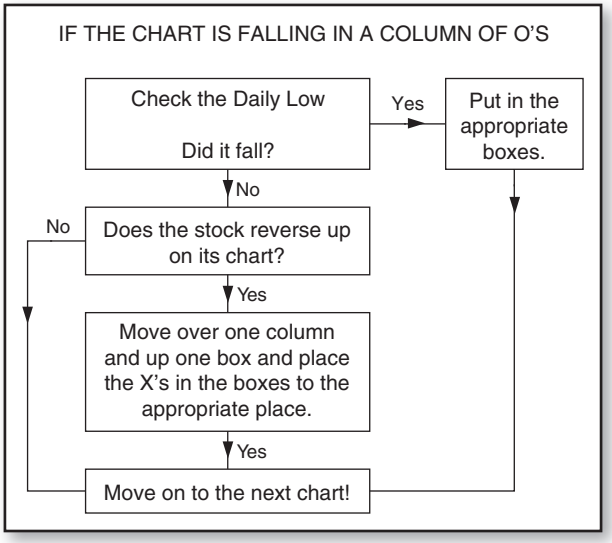


FIGURE 2.3 The Flowchart for Charting

full box or more on the chart?" If the stock did decline one more box, let's say from 45 to 44, then record that move by making an O in the 44 box and stop—go no further that day. Keep in mind all you are doing is recording what the stock does on each trading day, nothing more, nothing less. Don't think about the chart again until the close of business the following day. At the close of business the following day, you simply look at the high and low for the day (in the case we are now discussing, the low would be the most important) and ask the same question again. Since the stock is still in a column of O's, did it decline another box or more? Answer the question by looking at the low price for the day. If the stock in this case hit 43 or lower (declined one more box or lower), record the move by making an O in the box and stop. I don't care if the stock reversed later in the day and went to 100. You'll deal with that move tomorrow. You are concerned only with one direction per day. At this point, the stock is at 43 in a column of O's. Since the stock is still in a column of O's, the next day at the close of trading you ask the same question again. Did the stock decline one more box or lower? Today, the answer is no to flowchart question 1. The stock did not move lower by one box or more today.

Because the stock did not decline enough to close one more box today, you go to the second and last flowchart question. If the stock did not decline any further, or at least not enough to close another box, the second and final question of the flowchart is, did the stock reverse up three boxes? Let's think about this for a second. Did the stock reverse up three boxes? In this example, we are discussing a stock that is trading between 20 and 100, so the box size is 1 point per box. So a three-box reversal up would be 3 points higher than the last "O." Count up three boxes from 43, which would be 44, 45, and 46. Okay, did the stock hit 46? Let's say it hit 45.75. That's not good enough. That was only a 2.75 reversal, not 3. What do you do? Answer: nothing.

The next day, you go through the same process again. Since the stock is still in a column of O's, the first flowchart question that must be answered is, "Did the stock go down one box or more?" Get the picture? You go back to the first flowchart question and start again. At this point, there can only be two action points on the chart. The stock either does move one more box lower or it reverses up three boxes. The two action points that will cause me to make a mark on the chart are 42 and 46. Nothing else will cause a change on the chart. That is about as difficult as it gets in maintaining a Point and Figure chart. Okay, back to the example. If, over time, the stock does

reverse up three boxes to 46 by following these two flowchart questions, you will find the chart now one column over to the right and in a column of X's. The chart is now rising. The same process starts over again, only this time the first flowchart question is, "Did the stock move up one box or more?" That is really the whole ball of wax.

Once again, in a new example, it takes three boxes to reverse from one direction to the other. For example, if a stock were trading in a column of X's with a top of 45, it would take a move to 42 to reverse this chart to a column of O's: 45 – 3 = 42. Anything less than three boxes would be considered market noise, not worthy of recording. Conversely, if the stock in question were trading in a column of O's with a current low at 45, it would need a rise to 48 before a reversal into a column of X's could be recorded; as before, anything less than three boxes would be considered market noise. Figure 2.4 shows some examples of reversals. This back-and-forth motion is what creates the chart pattern that tells you volumes about what direction the stock is likely to go. Then you, the craftsman, will determine how it fits or not into your portfolio and how you will manage the position. It's so much fun you can't imagine until you understand this fully; then you will feel totally liberated from financial TV and newspapers.

I want you to think about this carefully. There is one exception to the preceding pattern. If a stock reversed from 21, for example, the required number of points would be only 2. This is because the stock will be moving through a level where the box size changes. If a stock is moving up (in a column of X's) through the upper teens and has a high of 21, a reversal would take place at 19, a move of only 2 points. The three boxes in this case are at 20; then, as the stock goes below 20, the box size changes to ½ point per box or 19½, 19, and so on. Once again, the box size between 20 and 5 is ½ point per box rather than the 1 point per box above 20. Keep break points in mind when you are charting at levels where the box size changes. If you just price the vertical axes properly, you need deal only with the boxes. Prices will take care of themselves. Keep it simple.

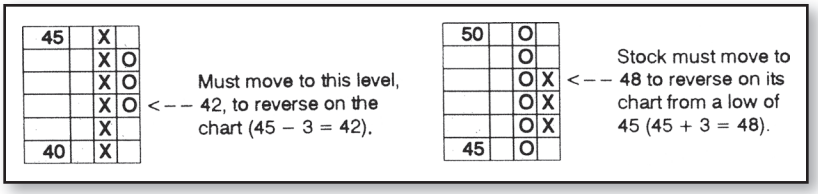


FIGURE 2.4 Examples of Reversals

Just assign the proper point value to the box—½, 1, and so on—and then count three boxes. This brings you to the actual charting. The daily high and low quotations for a stock are all that you will need. In today's Internet world, all you need to do is go to our web site and we do all the work for you. If you choose to do it by hand, most newspapers have a financial section, but quotes are limited. Sites like Yahoo! Finance would serve your quote needs perfectly. Once you have the quotes, the only prices you are concerned with are those that cause changes in the chart. For example, a stock is in a column of X's and has a high of 28.875. For charting purposes, we would read this as 28 because between 20 and 100 there are no fractions in the boxes. Each box is 1 point. In this case, .875 is not enough to close the box of 29. It's .125 too low. To the Point and Figure chartist, .875 is simply market noise when the box size is 1 point. If a stock is in a column of O's, you are primarily interested in whether the stock declined on that day of trading and you would look at a stock's low first. Using the same example, a stock has a low of 28.875. You read this as a low of 29. The stock must move to 28 to add another O to the chart. When you get a reversal of three or more boxes on a chart, you plot the reversal one column over and three boxes up or down depending on the direction of the reversal. The first change in direction would always be a three-box move because that is the minimum move required to shift columns. After the shift in columns, the moves could be as low as one box if you are continuing in the same direction. If the stock reverses down, you will plot an O one column over and three boxes down. If the stock reverses to the upside, you will plot an X one column over and three boxes higher. When reversing up or down, your count does not begin at the last number. Up means begin counting up one box. For example, to begin counting a reversal up where the last box closed at, say, 28 with an O, start counting up at 29, 30, 31. The first X of the three-box reversal up would begin at 29. A reversal down suggests you begin counting down one box below the highest X.

The only record of time in the Point and Figure chart is the replacing of the X or O with the number of the month when the chartist makes the first entry of that month. Placing the month in the chart has no significance except as a reference point. As the stock moves about, it alternates back and forth from one column to the next, X to O, O to X, and so on. At no time will you have an O in a column of X's nor an X in a column of O's. As previously mentioned, the first action point on the chart in any given month is represented by the number of the month. For example, if

a stock were to move up one box, you would add another X to its chart, but if that X, or plot, is the first one for July, you would use a 7 instead of an X in that box. Seven signifies the seventh month of the year, or July. This also holds true on down moves. For example, if a stock declined one box, and that is the first action point in August, you would put an 8 in the box instead of an O.

Let's cover it again. If the chart is rising, first check the daily high, and add an X if the stock has risen enough to close the next open box or boxes. You would add as many X's as needed to represent the stock's move. If the stock rose 4 points during the trading session, and each box equaled 1, you would put four X's on the chart. If the same stock moved up 5 points, you would add five X's. Flowchart question 1 would have been satisfied, and at that point you stop charting for that day. If, however, the stock did not move high enough to add another X, you go to flowchart question 2 and check the daily low to see if it has declined enough (three boxes) to reverse on the chart. The reversal is the key feature of the Point and Figure chart. If it did reverse, move one column over and one box down, then add the three O's representing the reversal. If the stock did not decline enough to warrant a reversal, then there is no action on the chart for the day. Remember, the three-box reversal means all three boxes must be filled before you fill any of them (2.99 points is not 3, and 3 is the requirement for a reversal if the point value of a box is 1). You cannot begin filling one box, then the next, until you accumulate three. The chart will remain in its current column until it closes (hits) all three boxes on the reversal. I am being purposely redundant because it is incredibly important that you understand the concept of charting before we go on to the fun parts of the book. You know what's cool about how technology does all the work for you? First, the system automatically charts all stocks for you anywhere in the world you want to invest. It also charts over 16,000 mutual fund symbols and over 1,400 exchange-traded fund (ETF) portfolios. It can also alert you to any changes you request, and it can be delivered to your smartphone. Once you understand how everything works, the system becomes your best friend and adviser. Every day I log onto our system at Dorsey, Wright, and I get goose bumps when I think of the power I have at my fingertips.

By using a three-box reversal method, we eliminate the minor moves that often occur in the market and look for moves that are significant enough to warrant representation. If a stock is declining, use the same process in reverse. Look first to see if the stock has moved down enough to add another O. If it has, add the O or O's. If the stock did not decline

enough to close another box, then look at the daily high to see if the stock has rallied enough to reverse the chart up. If it has, move one column over and one box up and add the three new X's. If it has not moved up enough to reverse, there is no action on that chart for the day. Some stocks can sit for months without any change. In volatile markets, the chart could continue in its present direction and then reverse. In other words, the stock rose enough to close another box with an X, but the last 20 minutes of trading that day, the stock declined 8 points on earnings news. You would simply stick to the flowchart, close the box with an X and forget the reversal at the end of the day. Remember, one direction per day. You will deal with that reversal tomorrow. It is a good idea to be aware of the stock's reversal at the end of the trading session, even though you don't record it on the chart that day. This can happen when earnings reports are released. The weak investors jump ship when in fact nothing has changed with respect to the company. It usually provides great buying opportunities. So this stock rises one box on the day, but late in the session the earnings are released. Let's say they are greater than Wall Street expected but the brain trust figured it would be the last good earnings for a while and sell. You see the "market" can interpret anything any way it wants. It's your job to listen to what the "market" is telling you, not the brain trust on TV. Either way, it could have the effect of immediately collapsing the stock price, thus producing what might seem like a reversal back down the chart. Remember, as I mentioned earlier, a chart can move in only one direction a day. In this case, you update the chart by moving it up in the column of X's. If the stock has moved enough late in the day to reverse, you will more than likely chart that reversal the following day, but not in all cases. For fun, let's say the TV brain trust misinterpreted the news and the next day the stock rallies on the opening to one box above the last X, then stays there the rest of the day. When you charted at the end of the trading session, you would find that you add one X to the chart and never saw the reversal the previous day. Again, remember, one direction one day.

If you have already gotten the hang of updating your chart, you can move along to the next section; if not, let's recap for a moment. We'll call it study hall. If a stock is rising in a column of X's, you will record any subsequent up-moves as long as that up-move equals or exceeds the next highest box. If the stock does not move up enough to equal the next higher box, then you look to the low to see if the stock reversed columns. To reverse into a column of O's from X's, the underlying stock must reverse three boxes to be significant enough to warrant a change in columns. Thus,

the action points in a stock that is rising and has the 50 box closed with an X will be 51 for another X, or 47 to qualify for a reversal into a column of O's. The opposite is true for a stock declining. The easiest way to chart is to determine your two action points before you seek the high and low for the day. In the preceding example, your action points were 51 and 47. That's all you look for in the high and low for the day. Did the stock hit 51? If the answer is no, then did it hit 47? If one of those action points was hit, record the correct price and stop and determine your next action points. Remember, our system does this all for you. Once you understand the concept of the reversal, you have mastered the nuts and bolts of this method. I urge you to keep studying this method. It will truly change your investment life. Sometimes we feel as if we are falling behind or failing when we try something new. Keep at it. Understand that once you finish this book, technology will do most of the driving, just like a state-of-the-art cockpit in a brand new Air Bus. You will become the architect of the portfolio, and technology will do the driving.

I like to think about Thomas Edison, who failed many times before he found the right path. Edison's life is a prime example of the American Dream. Without question, he was a giant among men. During his lifetime, he patented a record 1,093 inventions. Some of those inventions literally revolutionized the world. However, despite having one of the greatest minds in history, Edison, like all men, knew failure. In fact, he failed quite often. But like all great men, Edison accepted failure as a learning experience that would help him grow and develop. His son, Charles Edison, wrote about his father: "It is sometimes asked—didn't he ever fail? The answer is yes." Thomas Edison knew failure frequently. His first patent, when he was all but penniless, was for an electric vote recorder, but maneuver-minded legislators refused to buy it. Once he had his entire fortune tied up in machinery for a magnetic separation device for low-grade iron ore only to have it made obsolete and uneconomic by the opening of the rich Mesabi Range. But he never hesitated out of fear of failure. "Shucks," he told a discouraged coworker during one trying series of experiments. "We haven't failed. We now know a thousand things that won't work, so we're that much closer to finding what will." If you are reading this book, you are on your way to becoming a world-class investor by learning what works. Now it's time to take what you have learned and construct a Point and Figure chart based on a series of highs and lows. In Figure 2.5 we have provided you with a piece of graph paper to plot your practice Point and Figure chart. Using the data in Figure 2.6 and using the principles you just learned about charting and

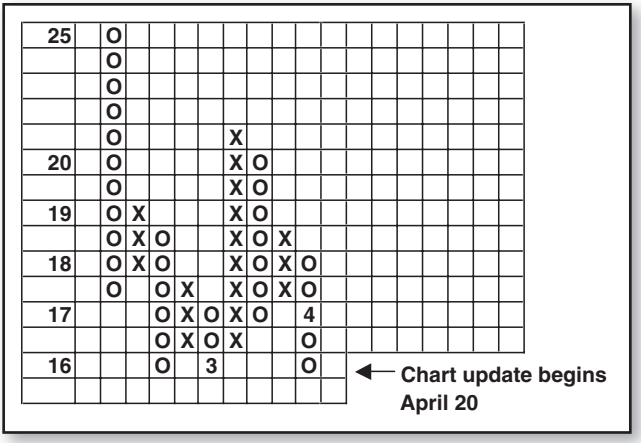


FIGURE 2.5 ABC Corp. Starting Chart

DATE	HIGH	LOW	LAST
20-Apr	16.625	16.000	16.000
21-Apr	16.250	16.000	16.125
22-Apr	16.875	16.375	16.625
25-Apr	16.750	16.500	16.625
26-Apr	17.375	16.500	17.375
27-Apr	17.375	17.375	17.375
28-Apr	18.125	17.500	17.750
29-Apr	18.125	17.625	17.625
2-May	18.375	17.500	18.000
3-May	18.250	17.875	18.000
4-May	18.250	17.875	18.125
5-May	18.250	17.500	17.500
6-May	17.750	17.500	17.625
9-May	17.750	17.125	17.125
10-May	17.625	17.125	17.125
11-May	17.625	17.125	17.375
12-May	17.500	17.125	17.250
13-May	17.500	17.125	17.375
16-May	17.375	17.125	17.250
17-May	17.500	17.125	17.250
18-May	17.625	17.250	17.375
19-May	17.625	17.375	17.500
20-May	17.625	17.250	17.375
23-May	18.000	17.500	17.625
24-May	18.875	17.625	18.875
25-May	19.625	18.625	18.875
26-May	19.750	18.375	18.500
27-May	19.125	18.500	18.875
31-May	19.375	18.875	19.000
1-Jun	22.250	19.625	21.750
2-Jun	20.500	19.500	19.750

DATE	HIGH	LOW	LAST
3-Jun	21.000	19.875	20.500
6-Jun	21.750	20.875	21.000
7-Jun	21.500	20.750	20.750
8-Jun	21.125	20.500	20.625
9-Jun	20.750	20.500	20.500
10-Jun	21.625	20.500	21.500
13-Jun	23.125	21.250	22.875
14-Jun	23.250	22.250	22.625
15-Jun	22.875	20.500	22.750
16-Jun	24.250	22.750	23.875
17-Jun	24.625	23.750	24.000
20-Jun	23.250	22.250	23.000
21-Jun	23.125	21.875	21.875
22-Jun	22.250	21.125	21.625
23-Jun	21.625	20.750	20.750
24-Jun	21.750	20.500	21.375
27-Jun	21.500	21.000	21.500
28-Jun	23.625	21.250	23.625
29-Jun	24.125	23.250	23.875
30-Jun	23.875	22.125	22.375
1-Jul	23.250	20.500	22.875
5-Jul	23.000	20.500	22.750
6-Jul	22.625	22.000	22.000
7-Jul	24.000	22.000	23.625
8-Jul	24.250	22.875	23.500
11-Jul	23.750	23.000	23.125
12-Jul	23.750	23.250	23.375
13-Jul	23.625	23.250	23.250
14-Jul	23.625	23.375	23.500
15-Jul	23.375	22.625	22.750

FIGURE 2.6 ABC Corp. Price History

using the simple two-question flow chart as your guide, plot a Point and Figure chart. As you plot this chart, remember that you are recording the supply-and-demand relationship of the stock in a logical, organized manner.

Practice Chart: ABC Corporation

We have used the price quotations shown in Figure 2.6 to construct the chart that appears in Figure 2.7. Take a look at that chart now. Notice how the last box closed in the chart in April is at the price of 16. We begin updating the chart from that point. Remember, the easiest way to maintain a Point and Figure chart is to determine where your action points are. If the chart is in a column of O's, the first action point would be one box lower than the last one recorded. If the stock does not decline low enough to record the lower box, then your second and last action point would be a three-box reversal up. In the case of ABC Corporation, the first action points from the bottom at 16 in April would be 15½ (one box lower) or 17½ (a three-box reversal up). From the 16 level, there are no other action points. Whichever action point is hit first, record it, and then determine your next action point. That, basically, is all there is to updating a chart. Always think of your two action points.

Using Figures 2.5 and 2.6, let's update ABC Corporation stock beginning at the 16 in April. As discussed earlier, there are numbers on the chart that correspond to the months of the year and provide a convenient reference point for the following steps:

1. On April 20, determine action points with the stock currently in a column of O's at 16. They are 15½ and 17½. Let's explain how we get these numbers one more time. Since we begin with the stock in a

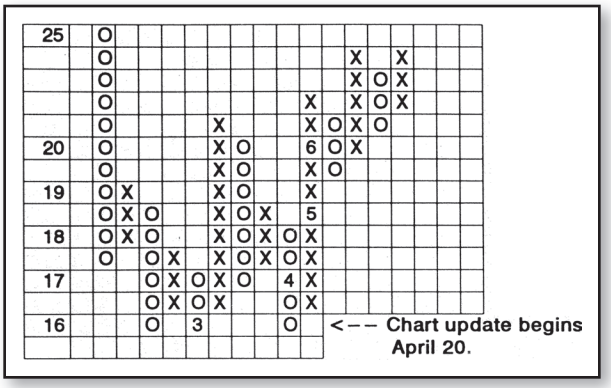


FIGURE 2.7 ABC Corp. Chart

column of O's, the 15½ action point is simply one box lower than the last one recorded at 16. The 17½ action point corresponds to a three-box reversal up. Remember that each box below 20 and above 5 equals ½ point. Three boxes represent 1½ points, thus 16 + 1½ = 17½. In this case, 17½ is hit before 15½. Notice how, on April 28, 17½ is hit as well as 18. This action causes the reversal plus one box. Now go up to 18 in a column of X's.

2. On April 28, determine your action points. They will be 18½ for a one-box rise or 16½ for a three-box reversal. Record whichever comes first. It takes until May 24 for the stock to move enough to be considered significant enough to record. The stock rose to 18.875 closing the 18½ box. This is a good example of why the Point and Figure chart is so important. The bar chartist would have been recording moves in the chart every day. The Point and Figure chartist would have done nothing from April 28 until May 24 because nothing significant happened between those dates. The Point and Figure chartist is not interested in noise.
3. On May 24, determine your action points. They are 19 on the upside and 17 for a three-box reversal. Now you wait to see which one is hit first, and then establish your next action points. Easy, huh? On May 25, the next day, ABC Corporation hit a high of 19.625. This closed the action point box of 19 as well as the next box above it at 19½.
4. On May 26, determine your action points. They are 20 and 18. If the stock increases one more box and hits 20, make an X. If, instead of rising, it falls three boxes to 18 or lower, reverse into a column of O's and represent the move. On June 1, the stock hit 22.25. You can now move up in X's to the 22 box. Notice how the box size has changed. It was ½ dollar (point) per box below 20, now it is 1 dollar (point) per box above 20 up to 100.
5. On June 2, establish your action points. They are 23 and 19½. The 23 one is easy, the 19½ action point might confuse you a little. Remember the break points in box size. Three boxes down from 22 would be 21, 20, 19½. Below 20 is ½ point per box. The very next day the stock declines to 19.50, so you will reverse into a column of O's. Supply had taken control for the time being. Your action points will now begin with one box lower to continue in the same direction, or a three-box or more reversal into a column of X's.
6. On June 3, establish your action points. The chart is now in a column of O's at the 19½ level. Your action points are 19 and 22 for a three-box

reversal. Once again, we cross the equator, the point where the box size changes from ½ to 1, so a three-box reversal up from 19½ is ½ point to 20, then 1 point to 21 and 1 point to 22. Note how the box size changes when you cross the 20 mark. Let's see which one is hit first. On June 13, the stock rises to 23, so the stock reverses up into a column of X's and the 23 box is closed.

7. On June 14, establish your action points. Since you are in a column of X's, your first action point is one box higher than the last one closed. That number is 24. A three-box reversal would be 20. So we are looking for 24 and 20. On June 16, 24 1/4 is hit, closing the 24 box.
8. On June 17, establish your action points. We are looking for 25 or 21. A one-box rise is represented by 25 and 21, the three-box reversal. On June 23, the stock declines to 20.75. This reverses it back down the chart and into a column of O's. The 21 box is now closed with an O.
9. On June 24, establish your action points. We are looking for 20 and 24. On June 29, the stock hits a high of 24.125. The stock now reverses back up into a column of X's. The reversal forms a double top (we cover these patterns in Chapter 3).
10. On June 30, establish your action points. They are 25 and 21 for a three-box reversal.

This has been an interesting exercise because the stock crossed the equator a couple of times demonstrating three-box reversals using ½-point and 1-point box sizes.

One of the reasons Point and Figure charts are so practical is that the chart formations stand out because we move over and down a box when making a reversal. This is easily seen by looking at a chart that has just broken out. By moving down a box when the stock reverses down, the tops, or resistance areas, stand out. By moving up a box when the stock reverses up, the lows or support areas stand out. Figure 2.8 provides examples of such movements.

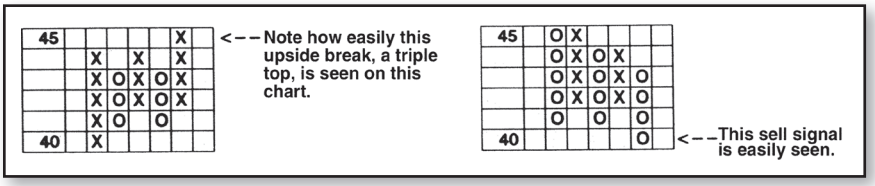


FIGURE 2.8 Buy and Sell Signals

Mutual Fund Charting

I've mentioned several times already in this book how technology changed the scope of analysis we do at DWA. One place this is evident is in our extensive mutual fund service. In 1997, we began to develop a database of mutual fund charts. This universe has burgeoned to over 16,000 mutual fund charts today. Many investors didn't even realize that you can plot Point and Figure charts for mutual funds, but when you cut to the core of a mutual fund, it is merely a basket of stocks just like the Dow Jones Industrial 30. The same principles for charting a stock can be applied to charting a mutual fund, with a couple of nuances. First and foremost, the flow chart for plotting a mutual fund chart is the exact same as a stock. In Figure 2.2, instead of looking at the high or the low, we look at the net asset value (NAV) at the end of every trading day. The first question we ask ourselves upon looking at that NAV is if we can continue in the direction the chart is currently going. If the answer is yes, we add the appropriate X's or O's and move on to the next chart. If the answer is no, we look to see if the chart has reversed. If so, we make the appropriate marks and move on. If the chart does not reverse, there is no action on the chart for that day.

Now let's talk about the nuances of plotting a Point and Figure chart on a mutual fund. The first is the mutual fund scale. The average fund trades at $15 a share. That is a basket of stocks, not just an individual name. Because mutual funds generally move slower than an individual issue, we have to "speed up" the chart. Instead of using a scale of ½ point per box, we instead use a default scale, also called the intermediate scale, of 20 cents per box. The short-term chart is half that size at 10 cents a box. The long-term chart follows the stock scale and is at 50 cents a box for this price range. Note that this scaling does adjust as the price of the mutual fund changes, but this is the scaling used for the average fund.

The box sizes differ to produce a sensitivity range that helps you in evaluating that mutual fund. Smaller box sizes make the chart more sensitive, also increasing signal noise. Bigger box sizes reduce sensitivity and reduce noise. Larger box sizes are best used to establish longer-term trends because they tend to show stronger areas of support and resistance. The purpose of using several different box sizes is to uncover the short-term action within the context of the longer-term trending. If we focus only on the long-term chart, we may miss the attractive short-term benefit from the fund. If we focus only on the short term, we may lose sight of the underlying long-term

trend. The art in the Point and Figure method is to correctly interpret both themes in tandem. This often leads to a better understanding of how to use a mutual fund within your asset allocation models.

Exchange-Traded Funds

I have been in this business for over 37 years now, and I'm almost sad to say that the rate of innovation on Wall Street has actually been pretty poor when you compare it to other industries. In 1973, the advent of the listed options market changed the financial landscape. It wasn't until the introduction of the ETF about 25 years later that Wall Street brought to market a new, innovative product that would forever change the way investors approach the market. I had spoken to one of the major exchanges about the need for an ETF-like product in the early 1980s, but it wasn't until the introduction of the iShares ETF product in 2000 that we began to see this product expand extensively in the marketplace. Without a doubt, I think the ETF product is the most important innovation on Wall Street in my 37 years in this business. It is so important that we devoted a chapter to ETFs in the second and third editions of the book and we devote a chapter to ETFs in this fourth edition. Later in the book we explore more history on ETFs, but for now I want to point out a subtle difference when charting ETFs and stocks. Much like a mutual fund is a basket of stocks, ETFs are baskets of stocks, too. Because of this, we find that the charts of an ETF move, for the most part, too slowly when plotted on a typical stock scaling system. At DWA we use a default box of 50 cents per box when plotting an ETF. However, you can easily change the box size by clicking on the side of the chart and selecting the size you want to use. I think it's very helpful to look at several box sizes. The larger the box size, the longer term the perspective. Conversely the smaller the box size the shorter the time frame you are evaluating. The more perspective you can get, the better your decision on how to position the ETF, mutual fund, or stock in your portfolio.

Trend Lines

Trend lines are one of the most important guides you have in Point and Figure charting. In fact, we have created a new sector indicator by aggregating trend lines, the percentage of stocks trading above their trend lines. We will

discuss this indicator in Chapter 8. I am always amazed at how a stock will hold a trend line on the way up or down. Trend lines are very easily drawn using the Point and Figure method, whereas bar chart methods involve a lot of subjectivity. Two basic trend lines are used in Point and Figure charting: the bullish support line and the bearish resistance line. We discuss each of these separately, as well as two other trend lines: the bullish resistance line and the bearish support line. For long-term investors, a stock's main trend is always bullish if it is trading above the bullish support line. I call this line Interstate 95 North. On the East Coast, I-95 is the main artery moving north and south. Conversely, a stock's main trend is said to be bearish if it trades below the bearish resistance line. I call this line Interstate 95 South. These trend lines are typically used for long-term investors. Traders are much more flexible and find that the truth lies somewhere in between most of the time.

Bullish Support Line

The bullish support line is a major component of a stock's chart pattern. It serves as a guide to the underlying securities trend. Typically, these lines are like brick walls. It is uncanny how so many stocks will hold the trend line as they rise in price. In general, investors should not buy stocks that are not trading above their bullish support lines. Drawing the line is very simple and has not changed since the inception of the Point and Figure method. Once a stock has formed a base of accumulation below the bearish resistance line and gives the first buy signal off the bottom, we go to the lowest column of O's in the chart pattern and begin drawing a trend line starting with the box directly under that column of O's. You then connect each box diagonally upward at a 45-degree angle. Unlike bar charts, which connect prices, the Point and Figure chart never connects prices. The bullish support line will always be a 45-degree angle (See Figure 2.9). The bearish resistance line will always be the reciprocal of the 45-degree angle, a 135-degree angle.

We typically give a stock the benefit of the doubt if it gives a sell signal while it is trading close to the bullish support line. Once a stock rises significantly above this trend line and gives a sell signal, followed by another buy signal, a shorter-term trend line can be drawn. Simply go to a level that is one box below the bottom O in the column that gave the sell signal and connect the boxes up diagonally. This will serve to be your new trend line, although I would still leave the first trend line

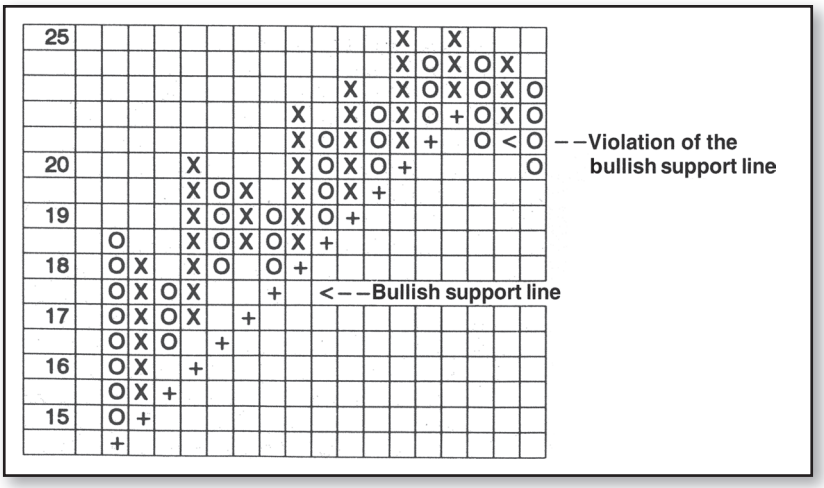


FIGURE 2.9 The Bullish Support Line

intact because it will give you some longer-term perspective. The first bullish support line will always serve to be the long-term trend line and may very well come into play years later. These shorter-term trend lines serve as visual guides. The short-term trend lines can also be valuable in identifying the short-term direction of stocks. Traders often initiate a long trade when the stock has declined near the bullish support line because the stock is then close to the stop-loss point. Technology plays in to the trade as you can set an alert on the Dorsey, Wright system to be received via e-mail or text message if the stock breaks the trend line or gives a sell signal. Set the alert and let technology take it from there. This way, you don't have to look at it daily.

The most important characteristic of the Point and Figure method is its clear guidelines for whether a stock is on a buy signal or a sell signal and whether it is in an uptrend. But above all, remember this is an art not a science. H_2O does not necessarily equal water in the investment world. You are an integral part of the equation—never forget that. Many investors are looking for the black box that can make them instantly wealthy without becoming personally involved. It ain't happening. Like commercial aircraft today, they still require a pilot to be present even though the plane can take off, fly the route, and land by itself. You are the pilot even though our technology can manage the portfolio itself. You will find that this method is equally effective in helping you avoid the big hit as it is in helping you to buy the right stock at the right time. Often

in investing, it's what you did not buy that is responsible for your success. Think about this for a second. Today our Dorsey, Wright database can handle the management of the portfolio by itself. But it cannot just create a portfolio out of thin air. You, the architect of the portfolio, must convey to the computer what it is you want it to do. Once you do that, the computer can give you the right list of stocks to hold in the portfolio and handle the management of the portfolio by itself—that is, if you have given it the rules you choose to follow in managing the portfolio. We have numerous models you can choose from that automatically manage themselves. The system will tell you what to sell and what to replace that particular ETF or stock with. You will always be an integral part of the investment process. Our computer systems are here to save you time and help give you your life back so you can go about your day. Anything that is of importance in your portfolio can be delivered to you on your mobile phone. Like I said before, it is all going to the phone, including portfolio management.

Bullish Resistance Line

We rarely use the bullish resistance or bearish support lines. The more lines you begin drawing, the more complicated it becomes. The next thing you see is a screen that looks like the old game of pick-up sticks. Keep it simple. That being said, the bullish resistance line is drawn by moving to the left of the last buy signal (at the point the signal was given, where the X exceeds the previous column of X's) and going to the first wall of O's to the left. Remember, it is not the first column of O's but the first wall of O's. A wall of O's is usually that last down-move in the stock from which it begins to bottom out. This is the point where demand begins to take the upper hand. Then go to the column of X's right next to the wall of O's and begin drawing your trend line, beginning with the empty box above that top X. This line will be a 45-degree angle, as is the bullish support line. Typically, a stock will encounter resistance as it moves to the bullish resistance line, though this line may have to be drawn a number of times. The boundaries of the bullish support line and the bullish resistance line form a trading channel. In Figure 2.10, the bullish resistance line is drawn from the wall of O's beginning at the 21 level. In reality, we do not use these lines much at DWA and they are not drawn on our Internet site (www.dorseywright.com). We tend to be much more concerned with the bullish support line when a stock is rising.

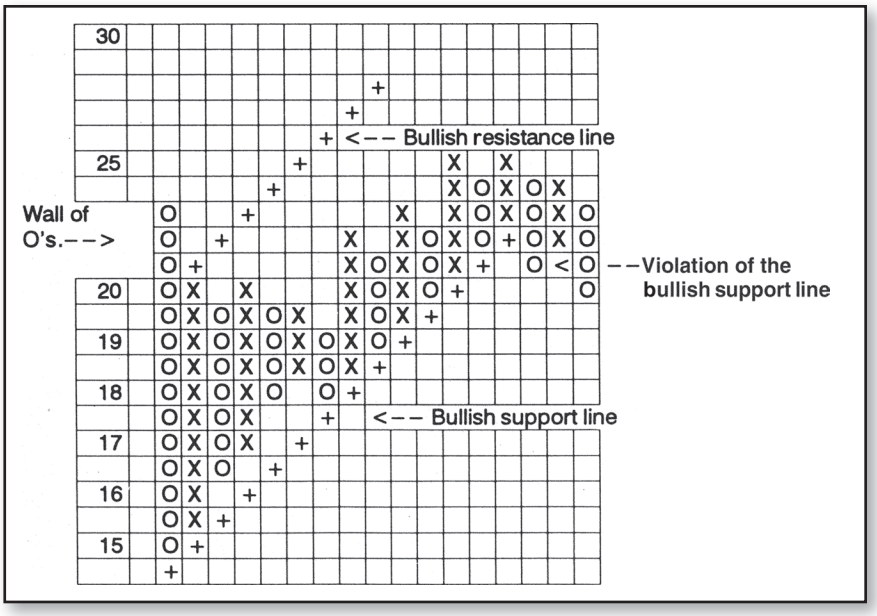


FIGURE 2.10 The Bullish Resistance Line

Bearish Resistance Line

The bearish resistance line, which is the exact opposite of the bullish support line, is shown in Figure 2.11. When a stock forms an area of distribution above the bullish support line and gives the first sell signal, you can go to the top X and begin drawing the trend line in the box directly above that last column of X's. Next, connect the boxes diagonally down in a 135-degree angle, the reciprocal of the 45-degree angle of the bullish support line. Actually, all you need to do is connect the boxes and the angle will be 135 degrees. The same principles and trading tactics apply in reverse to the bearish resistance line. We typically prefer not to go long when below the bearish resistance line. This line, like the bullish support line, can be as strong as a brick wall. We say a stock is bearish when it is on a sell signal and below the bearish resistance line. Or, as I often say, the stock is on I-95 South. Be wary of buy signals that come from just below this resistance line, as they tend to be false or best suited to traders. Stocks that are moving up to this line typically find formidable resistance there. Also, a stock must be on a buy signal to penetrate the bearish resistance line. Short sales can be initiated in weak stocks when the underlying stock rallies up to the resistance line but is still below it. This is the optimum point to sell short on any of the bearish chart patterns.

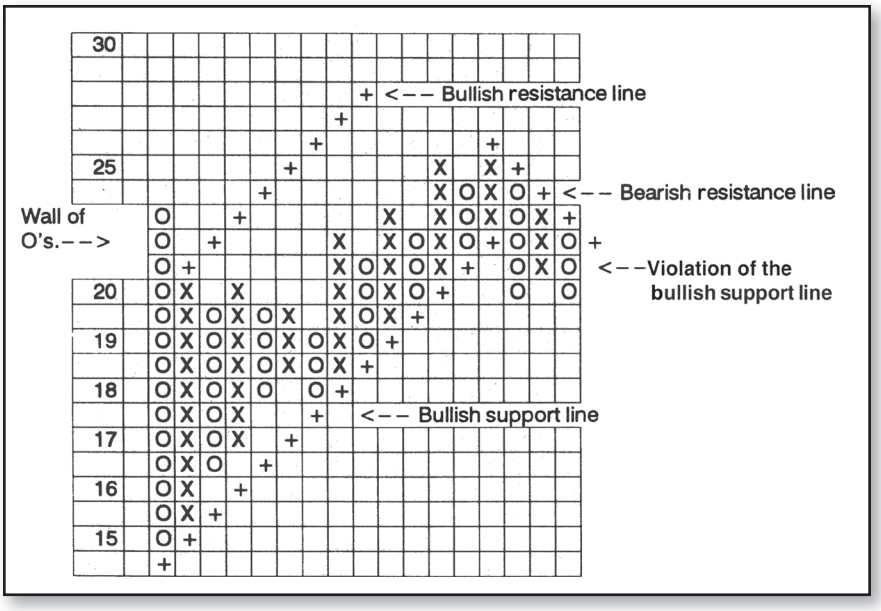


FIGURE 2.11 The Bearish Resistance Line

Bearish Support Line

As shown in Figure 2.12, the bearish support line is the reciprocal of the bullish resistance line and is drawn by moving to the left of the bearish resistance line to the first wall of X's—again, not to the next column of X's but to the first wall of X's. Then move to the first column of O's next to it and begin drawing your support line down from the empty box below the last O. The line, which will automatically be a 135-degree angle by connecting the diagonal boxes, can be used as a guide to identify where any decline might be contained. The bearish resistance line and the bearish support line in combination form a channel that the stock can be expected to trade in. Movement down to the bearish support line is likely to cause bottom fishing as investors create demand supporting the stock at that level. As the stock rises to the resistance level, investors who have been stuck holding the declining stock will elect to sell on rallies.

Price Objectives

Price objectives in Point and Figure technical analysis are derived through two methods called the *horizontal count* and the *vertical count*. The charts on our web site automatically calculate the vertical price objective for

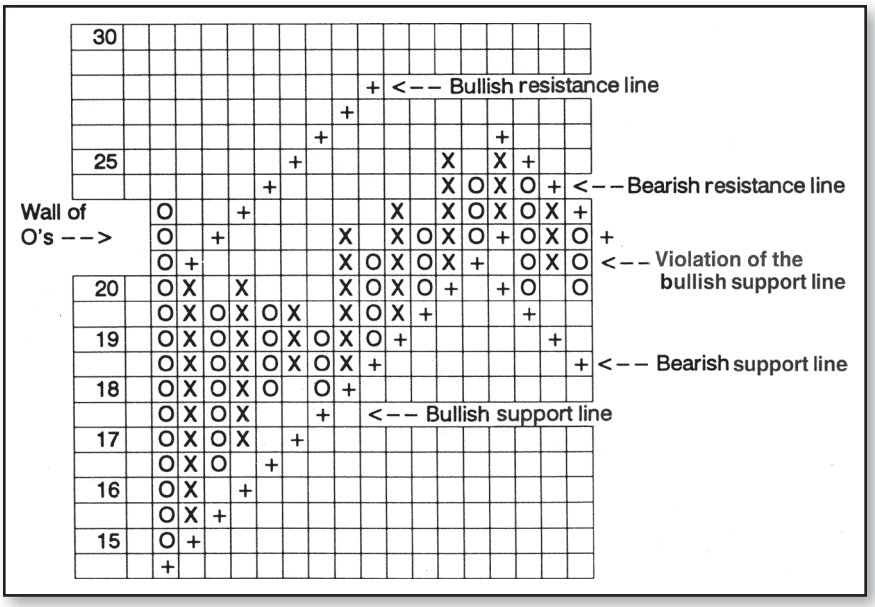


FIGURE 2.12 The Bearish Support Line

you. But again, while the computer saves us a lot of time in doing some of these calculations, you need to understand where they come from. The methods of determining price objectives come from the science of ballistics and have been used in Point and Figure analysis for many decades. The distance a bullet will travel can be calculated if the following factors are known—the size of the powder keg that will propel the projectile, the length of the barrel, the resistance the projectile will experience traveling through the barrel, the air temperature, and the attitude of the rifle. The best definition describing this science was written in an *Encyclopedia Britannica* article in the 1920s. The following passage is from the book *The Point and Figure Method—Advanced Theory and Practice* (New York: Morgan, Rogers, & Robertson, 1934):

> Exterior ballistics is that part of the science of ballistics in which the motion of the projectile is considered after it has received its initial impulse. The factors involved are the pressure of the powder or gas in the chamber of the gun from which the projectile secures its initial velocity, resistance of the bore before the projectile leaves the barrel, the resistance of the air, and the influence of gravity, all must be calculated in order to determine the probable objective of the projectile.

These same principles have been applied to stock and commodity trading to arrive at a rough estimate of the price objective following a breakout of a consolidation area. The vertical count is the most reliable and should be used whenever possible. At DWA, we use the price objective as an ingredient for helping us determine our risk-reward ratio. Whenever we initiate a position, as an investor or trader, we want to have two points on the upside for every point on the downside, and the price objective is one of the tools we use in determining the risk-reward ratio. Other factors that we look at include trading bands and other resistance on the chart. We cover both of these concepts later on. But there is one statement we must make about price objectives here: Just because a stock hits its bullish price objective does not mean we will automatically sell that position. If relative strength and trend are still strong, we very well may elect to sell a partial position and hold on to the core position. In 2005, Apple Computer was on a tear. The price seemed like it would never stop. Taking profits on the first price objective would have left plenty of profits on the table. As I mentioned before, Apple has seen impressive gains since 2000. Our auto-managed computer model has had Apple in the portfolio since $100 and the stock still resides there. The price objective is best used for risk-reward calculations. Looking back at the chart of Apple, it was left for dead by all the brilliant reporters on Wall Street when it was $8. They expected it to file chapter 11 at any time. Then, in October 2001, in the midst of the dot-com meltdown, Apple announced the new product it was bringing to market named the iPod. The announcement was enough to rally the stock from $8 to $12. The dot-com crash then took over again and all tech stocks resumed their downtrend. Apple slid to around $8. Still nowhere near its lows in 1997. Once the dot-com crash played itself out, Apple took off like a homesick angel. The iPod was a total game changer, as were the iPhone and the iPad. The stock has not stopped going up yet.

Vertical Count

When a stock finally bottoms out and begins to move up, it will give a simple buy signal at some point. A buy signal comes when a column of X's exceeds a previous column of X's. Once a buy signal is given, the stock will rise to a certain level where supply again takes over. It's like throwing a tennis ball up in the air. The ball will rise to a certain level before gravity takes hold and the ball begins to revert down. Stocks are the same. They will rise to a certain level where supply comes in for whatever reason. Supply overtakes

demand, and the stock reverts to a column of O's. When the stock reverses into a column of O's, the first column of X's off the bottom is finished. No more X's can be placed in that column. At this point, count the number of boxes in the column of X's, and multiply times 3 (if you are using the three-box reversal method). Then multiply that figure by the value per box. Add the result to the bottom of the line of X's (where that column began). This will give you a rough estimate of the stock's price objective on that move. Remember, the price objective is a guide, not a guarantee. It is not set in concrete, because many stocks meet their first price objective and continue on up, so keep the chart formation, trend line, and relative strength in mind when deciding whether to sell the stock. The fact that a stock has met its expected price move does not mean you must sell. It does, however, suggest you reevaluate its potential from that level.

Notice that in the example of the vertical count shown in Figure 2.13, box sizes change. You must first count the boxes below 5 as each box represents ¼ point. Then count the boxes above 5 as they represent ½ point per box. There are four boxes representing ¼ point. Multiply them by 3 and then multiply that number by ¼ (4 × 3 = 12 × ¼ = 3). Now count the boxes above 5 and ending at 8. There are six boxes at ½ point per box (6 × 3 = 18 × ½ = 9). Now add the two counts together, and you get (3 + 9) = 12. Okay, here's the last step. Add the 12 to the dollar value at the first box in that column. The potential move is 4¼ + 12 = 16¼. This example helps you understand how to use the count at breakpoints.

Vertical Count for Short Sale

Calculating the vertical count for a short sale is similar to that of a long position with one exception. Instead of multiplying the move by 3, you multiply by 2. In Figure 2.14, we count the number of boxes in the first down move

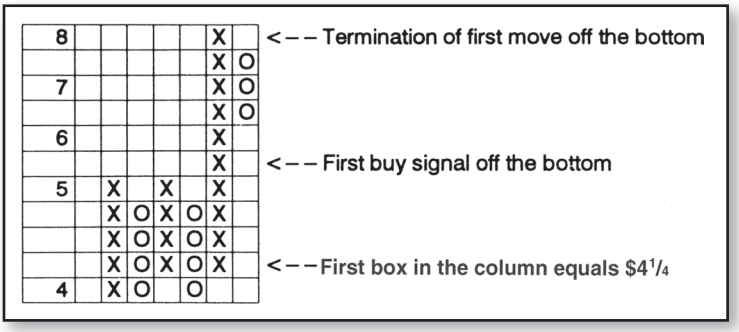


FIGURE 2.13 The Vertical Count

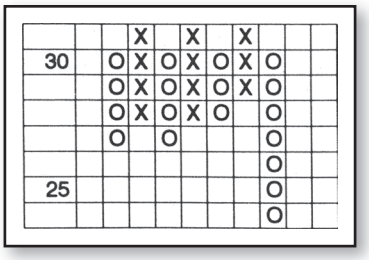


FIGURE 2.14 The Vertical Count for a Short Sale

off the top, which creates the first sell signal. There are seven boxes in that column. Multiply 7 by 2 and that comes to 14. Now multiply 14 by the box size, which is 1. That comes to 14. The last step is to subtract 14 from the level of the first O in the column, which is 30. The price objective is 30 – 14 = 16.

Horizontal Count

A horizontal count is taken by counting across the base a stock has built, multiplying by three, and then multiplying again by the value per box. This is similar to the vertical count except you count horizontally across the formation as opposed to the vertical move off the bottom. We look at the horizontal count as an exercise in counting the size of the powder keg that will propel the projectile. In ballistics, the powder keg is the amount of gunpowder in the shell casing, and the projectile is the bullet that will fly when the charge is detonated. I associate the vertical count with the distance the projectile travels before gravity takes control and pulls the bullet back to earth. This analogy, as well as the earlier tennis ball analogy always helped me understand the concept of the count when I was learning this method many years ago. Try to keep this as simple as possible because the count is only a guide. It is far more important to consider the market, sector, relative strength, and chart pattern when initiating a long or short position. This book places more emphasis on these variables than on the count.

In Figure 2.15, you would simply count the number of boxes horizontally at the widest point of the formation. That number is multiplied by 3, and the product of that multiplication is again multiplied by the box size. Looking at Figure 2.15 and counting across the widest part of the formation, both

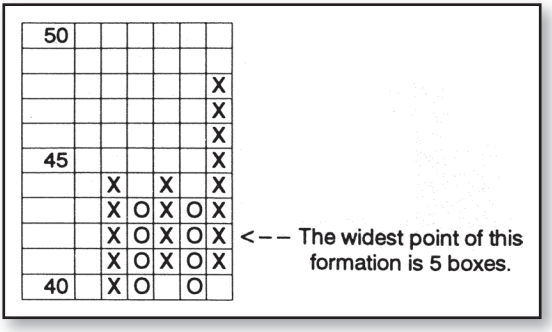


FIGURE 2.15 The Horizontal Count

X's and O's, you get 5 columns. We then multiply this by 3. Finally, in this example, the box size is 1 ($5 \times 3 = 15 \times 1 = 15$). Then add the product of this multiplication to the lowest point of the formation, which is 40. The expected move is thus $15 + 40 = 55$. Again, where the count really comes into play is in determining your risk-reward relationship. You should have at least two points of potential profit for each point potential loss before initiating a trade. Keep in mind that there are thousands and thousands of stocks to trade. Don't get hung up on one stock for any reason. There is always another train coming down the track. All you have to do is watch for it. Or, better yet, let technology watch for it.

CHAPTER 3

Chart Patterns

Recording the Battle between Supply and Demand

The nuts and bolts of the Point and Figure method have not changed for over 140 years, and this is good news. Once you learn the patterns, and they are fixed in your mind, the computer will do the rest. Though we always find new ways to use this method, we never step out of the basics of Economics 101. The backbone of Point and Figure analysis is the chart pattern. The beauty of this method is its ability to form simple chart patterns that record the battle between supply and demand. The reason this method is so credible is that it is founded on the irrefutable law of supply and demand, which affects our lives on a daily basis. Although just about everything we come in contact with has some association with supply and demand, it wasn't until my first course in college-level economics that I really thought about and came to understand this basic law. Heck, for the previous 22 years I had simply taken price change at face value—prices changed and that was it. It was that Economics 101 class in college that taught me to appreciate the laws of supply and demand. You know what? Most people never gain a full understanding of it. When I learned the concept of elasticity of demand in that course, I would go into supermarkets without a penny in my pocket and walk around and marvel at prices. I would go to the meat department and look at the price of steak and then think that if that price rose versus chicken, then people would intuitively switch from steak to chicken. This is called *unitary elasticity.* I would then go to the pharmacy section and think of insulin. For those with diabetes, insulin is a must for survival no matter what the price. This is called *perfectly inelastic;* a given change in price would yield

no change in demand. It was intoxicating to "understand." I felt empowered and gained a good understanding of how elasticity of demand affects life and people's spending habits. I strongly feel that as a requirement for high school graduation every student should take an economics course using the textbook *Economics in One Lesson* by Henry Hazlitt (New York: Random House, 1981) and pass it with a B or better, if for no other reason than that they will become more aware of the daily economic forces that affect their lives. Since it seems unlikely I'll be elected to any office where I will be able to institute this course of instruction, it will have to remain in the pages of this book. Take it to heart and have your kids learn these basic concepts. They will be well rewarded later in life with clarity of vision others will never have.

While many of the concepts I learned in Economics 101 have been improved on over the years, one remains unchanged—supply and demand. It is the driving force behind all price changes. If there are more buyers than sellers willing to sell, then the price will rise. If there are more sellers than buyers willing to buy, then the price will decline. This is as true for the price of tomatoes as it is for the price of stocks. It is as simple as knowing why we have lemonade stands in the summer and hot chocolate stands in the winter. Although these price changes affect our lives on a daily basis, we rarely think much about the law that governs these changes. In the third edition of this book, I mentioned we were in an energy crisis, with oil at $70 a barrel. Oil is now at $100 a barrel and there is no one crying about a crisis. In fact, this is instructive. Five years ago the public was looking for someone to hang with oil at $70 a barrel. I just Googled articles on high oil prices to see what showed up for December 2011. The top article that came up is entitled "Today's High Oil Price Is the Norm—Political Expert." The next article was entitled: "Reality, Why High Oil Prices Are Here to Stay." How things have changed. Elected officials have not demonstrated one shred of knowledge of economics. It truly amazes me. One idea Congress came up with in 2006 was to tax the heck out of the big oil companies with a windfall profits tax. If that were to be instituted, big oil would simply produce less of what is being taxed more, and the result would be shortages and higher gas prices. What it would do is gain votes for the politicians who proposed it. The votes these politicians would garner would most likely come from those who would be most hurt by the legislation. Politicians say the oil companies need to pay their fair share, and the electorate responds, "Hell, yes, stick it to those oil companies," I have not seen anyone explaining to the American investor why it takes 800 government permits to build one new refinery. This is not a problem that will be fixed by current legislation.

We need legislation allowing more refineries to be built. Old refineries are inefficient and cost more to operate, and do you know who pays for it? You do. The more it costs to refine, the higher the price of gas. The energy crisis or noncrisis is a topic for a whole book. Suffice it to say, Adam Smith's "Invisible Hand" is working well. The interesting thing is that in the past five years we have come from almost marching on Washington with regard to $65 oil prices to today where we are perfectly fine with an increase of 42 percent in the price of oil. Will we become used to $200 per barrel oil? I'll bet we will.

In the stock markets, prices change daily. Buyers and sellers battle it out for control of the stock. Eventually, one side wins the battle and the stock begins to take on a trend. For example, the battle between supply and demand was won by demand in oil stocks in 2002. Had investors been able to figure this out, as we did, they could have purchased oil stocks and offset any increase in gasoline along the way. And, today, there are exchange-traded funds (ETFs) that trade gasoline so investors can directly hedge their rising gas prices. So this battle between supply and demand manifests itself in the chart of the underlying investment vehicle. Over the near term, stocks seem to move back and forth randomly the same way players may win alternate sets of a tennis match. Eventually, a tennis player will win enough sets to win the match. The same happens with the tennis match between supply and demand. It seems to meander aimlessly in the short term, but long term a trend eventually develops. Either demand or supply will win. You must pay attention to know which one is controlling the stocks you own.

History Repeats Itself

The usefulness of the Point and Figure chart patterns lies in their repetition. The patterns of a Point and Figure chart tend to repeat themselves, and thus provide a high degree of predictability about the future move of the underlying stock. When teaching the importance of chart patterns in the Point and Figure Institutes held in Richmond, Virginia, I have in the past started the session with the following example: I throw a ball to someone in the audience without the participants knowing I am going to do it. The person's automatic reflex is to reach up and catch the ball. Then I throw another ball into the audience, and then another. Even though the participants know what is coming, the natural reflex is the same—they hold up their hands to catch the

ball. This is just like a Point and Figure chart; the pattern is repeated. Every time the market throws a triple top, or a bearish signal reversed pattern, or a bearish triangle pattern at me, I know the action that I must take. More often than not, the action taken was the right one. All too often, investors buy stocks that are clearly being controlled by supply simply because they never venture past the fundamentals of the company. Keep in mind, in 2008, as I said before, there were many fundamentally sound stocks that collapsed. There were no technically sound companies that collapsed. They gave warning signs as the chart pattern turned negative. That year should have shown any skeptic that there is more to stock price movement than fundamentals. Meltdowns like that begin with supply decidedly overtaking demand, plain and simple. What we try to do is stack as many odds as possible in our favor before we make a stock commitment. These odds include fundamentals and technicals, but if the technicals on a fundamentally sound stock suggest that the stock is clearly being controlled by supply, forget the stock—there are 10,000 others.

While the chart pattern is very important in the decision-making process, other factors should go into any decision. The Point and Figure method is an art, not a science. Many investors think they can simply look at a particular chart pattern with no additional evaluation of things, like the market in general or the sector, and experience instant success. It just doesn't work like that. What is important is to know the fundamentals of this method of analysis well first, and then you will be ready to implement your program using technology to do the work for you. One hard trend you can count on until your dying day is that technology will continue to advance. Right now, the way I see it is, think mobility. You have to be able to use your smartphone or smartpad anywhere in the world to manage your portfolios or your customers' portfolios. I use my iPad and iPhone extensively, but I anticipate a future where one day you will be able to ask Siri to construct a portfolio for you consisting of high-yield, technically sound stocks that all have strong relative strength versus the broad averages. We have the technology right now to make that happen. It will happen.

Increasing Your Odds of Success

A good friend of mine, the late Jim Yates, used the following analogy when explaining profits and probabilities: Consider a basketball game in which one player is dribbling the basketball down the court. Along the way,

he receives a personal foul from an opposing team player. A personal foul simply means the player can go to the foul line and take two shots (free throws) at the basket, unencumbered by the opposing team. Each shot he attempts is independent of the other. Prior to his shooting, the television commentator says that this player is a 70 percent free-throw shooter. This means that he will make 7 out of 10 baskets when he attempts a free throw. Keep in mind that he has two opportunities to make a basket, each one independent of the other. What is the probability that he makes both shots? When I present this problem at seminars, most people will answer 70 percent, whereas the actual probability of making both shots is 49 percent ($0.70 \times 0.70 = 0.49$ percent). What this suggests is that this basketball player, over time, will be successful less than half the time at successfully completing two free-throw shots.

You, as an investor, have the same problem. You must perform two tasks correctly, each one independent of the other. You must buy the stock right and you must sell the stock right. Have you ever bought a stock, had it go up, and—before you sold it—watched it go right back down again? If you haven't, I have. I have also had the distinct displeasure of buying a stock and having it go right down without the benefit of a rise first. In the latter case, I never even made the first basket. This whole book is designed to help you increase your odds of success and have the greatest probability of making both shots. We outline the whole game plan as we go along.

Right now, let's deal with chart patterns. Chart patterns are like road maps. They are really not any different from a map you might study to find the best interstate for a vacation trip to New York from Richmond, Virginia. If you were to choose I-95 South instead of I-95 North, it would take you to Key West, Florida, first. Selecting the wrong route is a common mistake most investors make. They set out on a trip to New York from Virginia and choose I-95 South to get them there. They select a fundamentally sound stock that is clearly controlled by supply and likely to go down, not up. As a broker, I did this many times simply because I didn't know any better. My approach was like starting out on a road trip and taking the first road I hit as the direction to my destination. What we did back then was simply buy the stocks that research recommended we buy without any other input. We tended to emphasize the "what" question and never considered "when."

Many stockbrokers and investors buy a stock on the fundamentals because it is usually the only form of analysis they understand, and there is plenty of this type of research around. I'll bet most of you get unsolicited

stock hype research reports in your mail every day. I know I get them. This type of fundamental research is everywhere. Never forget, someone has a reason for sending it to you. That reason is not to help you become independently wealthy. It's probably to unload some stock on you. These stories catch the investors' interest because they are all hype. I'm in no way suggesting that fundamental analysis isn't important. It is essential in answering the question of what stock to buy; it is the first line of defense. It is generally the preferred method of analysis to create our inventories. Fundamentals, however, provide only half the equation. Fundamentals alone can get you into big trouble.

So let's say you gravitate to the fundamentals first. If you are a professional, you need this on your side if things go wrong. You use the fundamentals to select the stocks that will go through your technical filter. The next task is to determine whether the stock has a high probability of going up or down. This is the point where technical analysis comes into play. When I was a stockbroker, technical analysis was never used. It was considered black magic, even though it had been around in the United States for over 100 years. Back then, we sold the sizzle on the steak. That's what customers wanted to hear, and that is what we sold. Had my firm included technical analysis along with fundamental analysis and trained us to understand and use it, what a difference that would have made. It would have been like the Fourth of July for both brokers and customers. Today, most broker-dealers have given up on tactically managing portfolios. They have gone to strategic asset allocation or modern portfolio theory (MPT). This theory basically suggests that the market is efficient and all there is to know about any given stock or sector is already in the price. Therefore, there is nothing you can do to improve your odds of success. So stop trying. Brokers are taught this even though it has been a losing strategy for decades now. I asked a friend who was president of a brokerage firm, why they still push their advisers to use MPT when it has been so discredited over the years, and his answer was, and I paraphrase, "We have spent too much money and invested too much infrastructure in this to stop now." The concept is to spread the money over many asset classes and stocks; some will go up, some will go down, most will stay relatively the same, and we will rebalance twice a year by selling the good stocks and putting that money to work in the bad stocks. I can tell you this: during the dot-com crash, this concept would have wiped out a portfolio and did. Today, there are many new web sites that offer the same thing that brokers offer but charge only a small fraction of the cost to

investors. MPT has been reduced to 25 basis points at technologically advanced web sites like Wealthfront.com. Others that do the same thing are www.marketriders.com, www.smart401k.com, www.betterment.com, and www.sigfig.com, among many others. They have become a dime a dozen. Investors will become more familiar with them as time goes on and these companies put more money into advertising. We are living in a deflationary world with respect to the investment industry.

Here is what happens when an investor goes into a branch office of a brokerage firm and asks for an adviser. The adviser sits down with the potential client and gives him a test to determine what risk tolerance he has out of three general categories. He could be aggressive, moderate, or risk averse. This is for compliance's sake. We know that everyone is moderate until the market goes up and he becomes aggressive, or the market goes down and he becomes risk averse. That is the real world. In the world of lawyers, compliance, lawsuits, and government regulation, the customer ultimately is disserved. It is my guess that the government eventually will dictate what a financial adviser can or cannot recommend to a client. It is already happening in the 401(k) world.

Suffice it to say that most brokers and investors look to fundamentals first, and in most cases last, too. At DWA, we used to look at several sources of fundamental recommendations to answer the "what" question, but today we do not find it necessary, though I still like to start with a list of fundamentally sound stocks that answer the "what" question. Take, for instance, the list of dividend aristocrats. These are stocks that have raised their dividend each year for the past 25 years. This can be a base of stocks that I will apply our technical filters to, to determine which stocks are the best bet at that given time. Most of the traditional brokerage houses publish reports available to all investors with their fundamental stock ranks. The Internet has fundamental information everywhere you turn. It's virtually everywhere and free on the Internet. Technical analysis is more difficult to find than fundamental, and the reason is that most technical analysis departments on Wall Street have been disbanded. America has gone to portfolio management and away from trading back and forth like it was when I was a broker. Most people back then had defined benefit plans; today, they are no more. 401(k)s are the mainstay retirement account American workers have. This means they need help managing it. People like me, who are in their 60s, are more interested in retirement than trading. Most brokerage firms embrace MPT, so anything that might detour an account from this outdated method of portfolio management is out.

Technical analysis gets hung up in the nomenclature of each method like Fibonacci numbers, waves, Gann angles, cycles, astrology, candlestick charts, line graphs, bar charts, and Point and Figure. This is the reason why many consider technical analysis black magic. I'll be honest with you, I don't understand nor do I want to understand any other method of analysis than Point and Figure. I took the easy approach to it. I knew that the last part of the equation before prices change is the battle a stock goes through with buy and sell orders. This battle between buy and sell orders results in a price. No matter what factor causes the price change, be it war in the Middle East, a fundamental change in the company, government policy change, or outdated technology, the last thing that has to happen before the price changes is either buyers overtake sellers or vice versa. If this is the case, and it is, then you have arrived at the Holy Grail. Just recently, we have seen a rash of sell orders accumulate in the dividend stocks, as taxes on capital gains and stock dividends are being contemplated in Washington. This has caused investors to sell these stocks at the end of 2012. Dividend stocks were the darling of investors for the past few years. This year they were dismal performers versus the Standard & Poor's 500 Index. The charts showed this change early on as selling pressure built up over buying pressure.

As I discussed in Chapter 1, the Point and Figure method was developed by Charles Dow as a simple, logical, organized, way to view this battle between supply and demand, nothing else. So why not go directly to the source rather than learning something that is many steps removed? You are reading this book so that you can take control of your investments. When you reach my age, you will need more money in your account than you started with. There is no one who will watch over your own investments more diligently than you. Actually, I should say in 2013, there is nothing that will watch over your portfolio more fastidiously than your computer or, better yet, your smartphone.

I want to give you a little dose of what our computer database did for us and our clients who wished to listen. This was in 2007; the meltdown of stocks, commodities, and housing had not happened yet. All of a sudden, we were able to see Bear Stearns and Merrill Lynch break long-term trend lines. This meant to us that these stocks had reversed from I-95 North to I-95 South. Wachovia was within a point of joining them. This spoke volumes to us about a dark cloud about to set over the brokerage industry. I am going to reprint some excerpts from our June 26, 2007, *Daily Equity and Market Report* to give you an idea of the type of research we write every

day. This will give you an idea of the type of research we write every day for our Daily Equity Report.

Subprime Now Sub-bullish Support Line: BSC & MER
DWA Daily Equity Report, Tuesday, June 26, 2007

The subprime loan area continues to cast its net further into the financial sector. First it started with the actual subprime lenders like New Century Financial (NEWCQ) and Accredited Home Lenders Holding Company (LEND) at the beginning of the year. . . . Now we see that the trouble in this area of the market has extended its reach into some venerable Wall Street names. Both Bear Stearns (BSC) and Merrill Lynch (MER) are making news headlines with Bear's two troubled hedge funds encountering trouble as security trades backed by subprime loans. The Point & Figure charts of these two stocks are making headlines of their own on a technical front. And not surprisingly, those headlines are not positive. Instead, we see that both Bear Stearns and Merrill have made very important technical breakdowns that are worthy of your attention. Let's take a look at both of these issues below and then we'll examine some other financial-related issues and ETFs that too may warrant your attention.

Keep in mind, at the time of this report, the fundamental ratings and recommendations were still rated buy on these stocks.

(MER) Merrill Lynch ($85.10): This Wall Street company bottomed out with many other equities in March 2003 and has been in an uptrend ever since, four years. We define the uptrend as the stock trading above the bullish support line. The bullish support line often acts like a brick wall with a stock coming down to test that support and bouncing off. This has been the case for MER on four tests; August 2004, April 2005, June 2006, and March 2007. All of these instances were periods where the overall market took a breather and so too did MER, but once the market got back on solid footing, MER moved on to new highs with the major market indices. That was the case until the most recent rally. In May and June as the Dow Jones and S&P 500 broke into new high territory, MER was unable to do so, not bettering its old highs of 98 made in January. In fact, as the market has been taking one step forward and one step back in June, MER has actually been taking two steps backward and only one step forward. The culmination of this action for MER was a move to 85.

The move to 85 followed two double bottoms at 91 and 87 and lower tops, but most importantly it violated the bullish support line. This support line again dated back four years to March 2003 lows and tells us that MER has moved to being on I-95 South instead of I-95 North.

[BSC] Bear Stearns ($142.06): This Wall Street company was a sector leader for years. A look at the peer relative strength chart of BSC shows a buy signal on August 3, 1999, to suggest that the stock is likely to outperform a basket of Wall Street names. BSC did indeed lead the way for the sector, posting gains of 244% compared to 140% while its peer relative strength chart was in X's. That eight-year run has come to an end, though, as the peer relative strength chart for BSC moved to a sell signal on June 20. But this is not the only ominous technical sign for BSC. The stock's market relative strength chart has reversed down into O's and the trend chart has turned negative. The overall trend of BSC has been positive since 2003 and the bullish support line just recently violated in March at 140 had been in effect since 2005. Besides just violating the trend line, BSC has been making lower tops and lower lows with the most recent breakdown coming at 142 last week, a bearish catapult formation.

With respect to managing risk, now is the time to review your holdings for potential trouble points in the financial related areas. It is also a great touch point with clients who are invariably reading about the trouble with these hedge funds in the news to let them know you are constantly monitoring positions for technical signs of weakness. While your financial holding may have no connection with the subprime loan area or hedge funds, the fact that it is in the financial area casts a shadow over the position and means that it should be monitored closely for any potential breakdowns. A case in point might be with Wachovia [WB].

[WB] Wachovia ($52.21): The trend chart of WB has been positive since January 2003. Over the last four years the stock has been moving higher along with the broad markets and marking new rally highs along the way. The new highs however stalled out in April of last year. Over the past year, WB has failed to make a new high on each rally, a negative divergence to the overall market. This is evident by the market relative strength chart which is in a column of O's and has been falling over the last year. In addition, we have now a sell signal on the chart, a double bottom at 53. WB has fallen another box on the chart to $52 and currently rests right at the bullish support line. A move to $51 will violate the bullish support line and this would change the trend to negative

for WB for the first time in four years. This would be a call to action for those who own WB to manage the risk in the position.

You know what? I'll never forget this report. Remember, our clients are primarily professional. We saved some retirements with this report. We got calls after the fact that some brokers who had their retirement tied up in their company stock took action and saved their hard-earned money. Many did not, but those who e-mailed us telling us they had moved out of harm's way have never left me. Others e-mailed us saying they wished they had listened. When you look back on a long career, these are the things that add up to success—helping other people. If you are not aware, Bear Sterns went bankrupt, and Merrill Lynch and Wachovia dropped to single digits. Both brokerage firms had to be bought out by banks, Merrill Lynch by Bank America, and Wachovia by Wells Fargo. Those who continued to believe solely in the fundamentals lost it all.

Chart Patterns

If you wait for the right chart pattern to form before making a stock commitment, you dramatically increase your probabilities of success. In our day-to-day operation evaluating and trading the markets, we have found that when the market is supporting higher prices (we cover these indicators in later chapters), sticking to the bullish chart patterns when going long a stock usually produces superior results. Conversely, we have found that when the market is not supporting higher prices, sticking to the bearish chart patterns when shorting a stock usually produces superior results. If the market is not supporting higher prices, your odds of success in buying a stock with a bullish chart pattern are analogous to trying to swim against the current. You may make some headway but not nearly as much as if you just wait for the tide to change so you can swim with the current. Think for a second about the salmon. Remember the pictures you have seen where they swim upstream to spawn each year? That's what it is like trying to make headway in the market with long positions when the prevailing market is bearish. I'll bet if you could interview a salmon, you would find that they would prefer to swim downstream to spawn if possible.

While I cover chart patterns as one of the first concepts in this method of stock market analysis, other indicators must be added to the equation before you can decide what to buy. The tendency of those new to the Point

and Figure process is to focus only on patterns when evaluating an individual equity. This is a very important step in the process, but not the whole process. That having been said, let's delve right into covering the Point and Figure chart patterns. It's important to know them well before you allow the computer to do the work for you. Had I known about this during my broker years, I would have been able to save a lot of heartache for both my clients and me. We always tried to recommend stocks that were fundamentally sound, but we never knew if we were on I-95 North or South. It is such a simple concept, yet most brokers and investors never get a handle on it. I remember a time I put on a trade for a client without paying much attention to the underlying stock. This good client of mine called to discuss some possible trades in the market. I had just learned about an option strategy called "covered writing" that involves buying a stock and simultaneously selling a call option against the position. The client and I talked at length about the stock. We discussed how Burlington Industries was a great company (the leader in the textile business at the time). He liked the covered-writing concept, so we did the trade, bought the stock, and sold the call option against the position. I sold it as a conservative strategy. I was really thrilled that I had been able to explain the concept of a covered write on the phone.

After the close of business, I went with my broker buddies to the Bull and Bear Club, as we did every evening, to have a beer and discuss the day's business. I mentioned to them that I had done a covered-write trade that day and the underlying stock was Burlington Northern. One of the fellows responded, "Oh, the railroad." I broke out in a cold sweat. I said no, I had bought the textile company, not the railroad.

As it turned out, I had in fact bought the client Burlington Northern, the railroad, despite discussing the merits of Burlington Industries, the textile company. The names Burlington Northern and Burlington Industries are close, right? Well, the names might be close, but their businesses are like the North and South Poles. The trade turned out fine, and I was probably better off with the railroad than I would have been with the textile company. In fact, Burlington Industries didn't even have listed options at that time. Talk about stacking the odds in your favor—I shut my eyes and took a shot in the dark. I wasn't sure what coast the stock was on, much less what interstate and what direction. This happens more often than you can imagine, but in most cases it doesn't turn out as well.

Many investors simply feel they can't grasp the nuances of the investment process to become better investors. They believe Wall Street is somehow

over their heads. But I've seen it time and again: brokers and investors who take that first "toe dip" into learning this material are quickly hooked and eventually become true craftsmen at the investment process. It's like the first time you learned to employ a little strategy in a game of chess or backgammon. Before you know it, you are hooked. It's intoxicating! But think for a second that we are in 2013 now. Once you decide to play the game of chess, you can simply call on "Big Blue" or better yet "Watson" to do the hard work for you. I'm serious. I want you to be diligent learning the patterns, and then you will simply learn how to let the computer search the patterns for you. It's kind of like letting "Watson" be your personal butler who handles the minutia in your investing life. "Watson" will alert you to anything that requires your attention. Yes, right on your smartphone. While you are out to dinner with your wife, a message pops up on your phone that XYZ just turned negative versus its industry group. Isn't this great? I love it.

Double Top

In Chapter 2, you learned how to maintain your charts. The most basic chart patterns are the double top and double bottom. The double top requires three columns: two columns of X's and one column of O's. The key to interpreting the chart patterns is to determine where the stock exceeds a point of resistance or support. A feature of Charles Dow's charts that caught the eye of some astute turn-of-the-century investors was the charts' accurate identification of levels of distribution and accumulation. Distribution corresponds to a top (resistance), and accumulation corresponds to a bottom (support). Resistance is the point at which a stock reaches a particular price and encounters selling pressure. Let's get back to the supply-and-demand scenario. This is the point where supply exceeds demand. For example, let's say that XYZ rises to 60 and meets selling pressure. This selling pressure exceeds the demand at that price, and the stock retreats back a few points. Remember, it requires a three-box reversal to change columns. If the selling pressure was enough to force XYZ back to 57 or lower, the chart would revert to O's from X's. In the tennis match analogy, supply would have won one set. The match continues. Let's say over the next few weeks, demand once again creeps back into the stock at 57 and causes the price to rise to 60 per share. This is another three-box reversal back up into a column of X's, and XYZ now sits at the same price level that previously found supply.

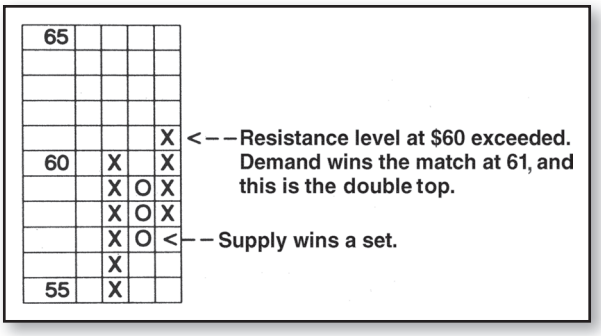


FIGURE 3.1 The Double Top

The question now is whether the sellers that forced the stock back before are still there. I have seen stocks hit resistance numerous times over many months before the selling pressure was finally exhausted. The only way to find out if the sellers are still operating at that price is to see how XYZ negotiates that level. If it is again repelled, then the sellers are still there. If it instead is able to move to 61, then we can say that demand has prevailed at this price by exceeding the level where supply was previously in control. By exceeding this level of resistance, the Point and Figure chart gives its most basic buy signal, the double top. Naturally, you must consider other things before purchasing the stock, but in this most simple pattern, we can say demand is in control. If you could give me no other information on XYZ, my decision would be to buy the stock. By XYZ's exceeding that point of resistance, we can say that demand won the match. The chart pattern would look like the one shown in Figure 3.1.

Let's cover the double bottom. In this pattern, supply wins the match. Let's say instead of XYZ's exceeding the previous point of resistance, it instead reversed and exceeded the previous level of support. You can see in Figure 3.2 that the stock declined to 56, at which point demand overtook supply and the stock reversed back up into a column of X's. At 59, the stock

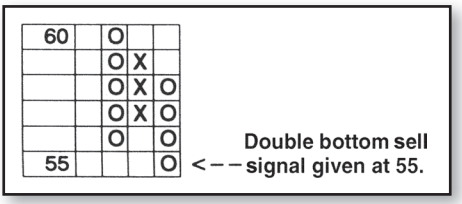


FIGURE 3.2 The Double Bottom

60		X		X		<-- Double top formed but unable
		X	O	X	O	to exceed that level.
		X	O	X	O	
		X	O	<	O	--- Previous level of support.
		X			O	<-- Exceeded previous support level.
55		X				double bottom sell signal.

FIGURE 3.3 Double Bottom with Resistance

encounters selling pressure that drives XYZ back down the chart to the 56 level, where demand previously took the upper hand providing support. This time, however, the buyers are not there as before, and the selling pressure persists until the stock exceeds that level of support. The match is over. Supply wins, and the probability is lower prices. The reason supply overtook demand is not important. How the stock reacts to the supply and demand is all that matters, for in the end, supply and demand cause stocks to move up and down and nothing else.

You can now see why we call these patterns double top and double bottom. The stock rises or declines to the same level twice. You can probably already guess what we might call the pattern if it rose or declined to the same level three times.

In Figure 3.3, you can see that when the stock rose back to 60, it was repelled for the second time. This clue suggests to us that there is formidable resistance at that level and the sell signal is that much more important. Looking at this chart, we can tell that the upside potential is only 60. Naturally, things can and do change, but this is all we have to go with for the time being. Short sellers always want to know points of resistance because a penetration of these levels might signal a reversal in trend.

Figure 3.4 shows us that there is good support at 55 simply because that is the price where the stock stopped going down on two separate occasions. For some reason, there are buyers at that level. We consider this a level of accumulation or support. This double top buy signal is more important than

60		O				
		O			X	<-- Exceeds resistance level.
		O	X	<	X	--- Previous resistance level.
		O	X	O	X	
		O	X	O	X	
55		O		O		<-- Double bottom formed but
						unable to exceed that level.

FIGURE 3.4 Double Top with Support

the previous one because there is more information available with which to make a decision. The stock found support twice at the 55 level, suggesting that the stock will hold there in the event it experiences further weakness—just a little clue the chart in Figure 3.1 did not have.

Bullish Signal

We add one more dimension, an added clue, to the pattern this time. In Figure 3.5, notice how the last column of O's does not extend down as low as the previous column of O's. We call that a rising bottom. It signifies that supply is becoming less a factor in driving the stock. On the other side of the coin, demand is getting stronger as the last column of X's exceeds the previous column of X's. The rising bottom provides added guidance when evaluating the supply-and-demand relationship of the underlying stock. Of the three double tops discussed thus far, this one is the strongest and would warrant the largest commitment.

The best way to understand these patterns is to take a legal pad and pencil and simply write down in 50 words or less exactly what you see (no different from the composition seven-year-olds sometimes have to write for homework, describing their room). This is what I observe in Figure 3.5:

1. I see a tennis match that took only four sets (columns) to complete.
2. I see two sets where McEnroe won (columns of O's) and two sets where Connors won (columns of X's).
3. The last column of X's exceeded the previous column, giving a double top buy signal at 60.
4. The second column of O's did not decline as low as the previous column of O's, suggesting McEnroe is losing strength.
5. The last column of X's exceeds a previous column of X's suggesting Connors is gaining strength.

Breaking the pattern down to its lowest common denominator simplifies analysis.

FIGURE 3.5 Double Top with a Rising Bottom

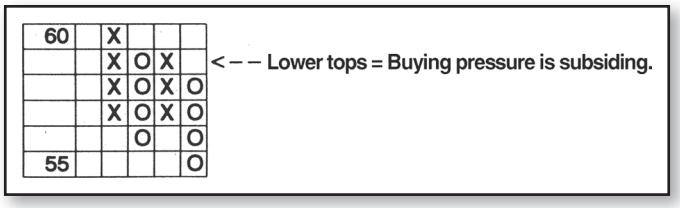


FIGURE 3.6 Double Bottom with a Lower Top

Bearish Signal

The bearish signal is the opposite of the bullish signal. Figure 3.6 shows that demand in this case is becoming less strong as the last column of X's fails to reach the previous level. Selling pressure, however, is increasing as evidenced by the lower column of O's. These clues simply suggest that demand is losing strength and supply is gaining strength. All too often, investors buy stocks in this condition only to see them erode further.

So far, we have discussed the double bottom and double top. All other patterns that we cover are expansions of this basic form. By now, you can see how simple this method is to grasp. Let's go on to the triple top buy signal.

Triple Top

The triple top is exactly what the name suggests—a chart pattern that rises to a certain price level three times. The first two times the stock visits that level, it is repelled by sellers. The third time the stock rises to that level, it forms the triple top. The buy signal is given when the stock exceeds the level that previously caused the stock to reverse down. This pattern is shown in Figure 3.7.

There are many reasons a stock will encounter supply at certain levels. Think back to a time when you bought stock thinking it was the bottom,

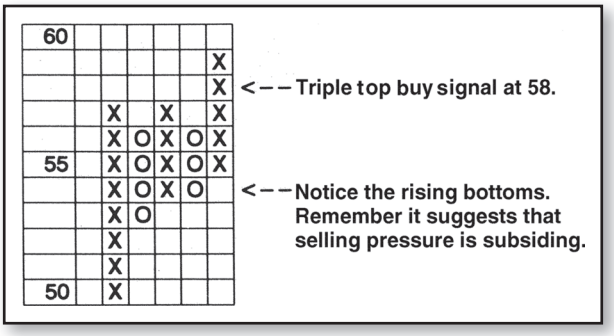


FIGURE 3.7 The Triple Top

or at least an opportune price level to buy, and instead of rising, the stock immediately declined. We have all had one or two experiences like that. The thought that probably crossed your mind as you saw the stock lose value was to get out if the stock got back to even. This is a perfectly normal human reaction. When you place that order to get you out at your break-even point, you are in essence creating supply at that level.

If more sellers are willing to sell their stock at that level than buyers are willing to buy, the stock will decline. The only way we know whether the selling pressure has been exhausted at a particular level is by the stock's exceeding that price. If the stock is repelled again, the sellers are still there. I have seen stocks bounce off certain prices for as long as 18 months. There have been numerous examples of this over the years. Coca-Cola (KO) from 1992 to 1994 was in a trading range with neither supply nor demand winning until finally, in September 1994, demand won and the stock took off. I like to use this example of KO because it was a stock I held in my children's accounts. The first time I bought KO was in August 1980. My son Thomas was born, and that day I opened him a stock account. He and his wife had their first child (our first grandchild) in February of this year. I have already opened her stock account. Back in 1980, I didn't have much money so I bought Thomas $600 worth of KO and Alcoa (AA). Over the years, KO was a super performer but AA was not. The account was carried by KO. I held that stock for 18 years until the relative strength chart turned negative. We got out right at the top. It has taken 14 years for KO to move back to its old top. That one stock, however, made enough money to pay for my son's college education. If you have not opened a stock account for your young children yet, do so!

Another memorable example was Intuit (INTU). This is a stock from back in the wild, wild days of the Internet craze. This stock spent 11 months trading between 23 and 35. Finally, when the stock broke out, it took off like a rocket, rallying to 90 in a matter of two months. When a stock trades up to an area of resistance numerous times and then finally breaks out, we refer to that as a "big base breakout." Intuit is still trading and doing well, making a new high in 2012, and is trading around $62. It had a two-for-one stock split in 2006, so the stock presplit is still trading over $124. In fact, as I write this, I am looking at the chart and I might just buy it. Yet another big base breakout that comes to mind is Cognizant Technology Solutions (CTSH). Between October 2008 and mid-March 2009, this stock traded within a range between $14.5 and $21, making it up to $21 four times, only to be repelled by resistance at that level. Finally, the stock hit $22, breaking a spread quintuple top, and there was nothing but grease between here and the trees

for that stock. As of August 2012, CTSH was up over 200 percent since its big base breakout in March 2009. In 2011, AT&T Inc. had a major big base breakout. In 2008, it lost 50 percent of its value, then began to move back and forth, creating a big base. In 2011, it exceeded a top in that base and the move was on its way. AT&T rose in 2012 from $29 to $38. Let's look at one more big base breakout, Apple, Inc. In 2000 the media had written its obituary. Then all of a sudden Apple changed the way we listen to music forever. The iPod came out. Since then Apple, Inc. has been the technology leader. This big base breakout happened around $12. The stock traded at $680 in August 2012. A little arithmetic suggests that 1,000 shares was worth $680,000. Not bad. I'm going to go out on a limb here. I'm betting Microsoft has its day again. Keep an eye on the chart of that stock.

Back to the triple top—expansions on the triple top are merely patterns that take longer to complete. Patterns like the quadruple top or quintuple top are rare. The more tops a pattern has, the more bullish; and the faster the pattern develops, the more bullish. The more times a stock bounces off a resistance level, the stronger the breakout will be when it comes. It was said years ago that the degree to which a stock will rise is in exact proportion to the time the stock took in preparation for that move. In other words, the wider the base from which a stock breaks out, the higher the stock will rise. In our 25 years of experience at DWA, we have found that a good strategy to use with the triple top or greater breakout is to buy partial positions on the breakout and then average in on a pullback. Half of the time, a stock will pull back after the triple top breakout.

Triple Bottom Sell Signal

The triple bottom sell signal, like the triple top, has a high degree of reliability. When I teach seminars on this subject, I use Figure 3.8 as an example

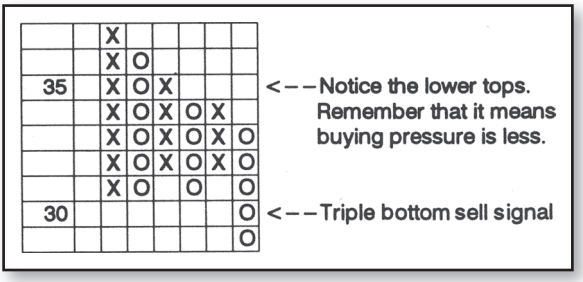


FIGURE 3.8 The Triple Bottom

of how dangerous it can be for investors to exclude technical analysis when buying a stock. Consider an investor who buys this stock at $31 per share and then leaves on vacation for one month. He checks the Internet frequently and notices that his stock is still around the price he paid for it, only down a point. Not bad for a market that had been volatile for the past month, he thinks, and he continues to feel comfortable with the stock. The fundamentals are all in place. What is he missing in this puzzle? What he is missing is that a whole tennis match between supply and demand has been completed, with supply winning the match. By not watching the match, he is unaware of it.

The probability of lower prices is very high. The triple bottom does not mean that the stock will cave in immediately; it suggests that the risk in that position has increased tremendously. Whether this investor chooses to do anything about the signal or not, he should at least be aware of it. If the investor does nothing other than increase his awareness of a potential decline, he is far ahead of the investor who holds the same position without any warning. Other considerations, such as relative strength, sector bullish percent, overall market condition, and trend lines, are discussed in later chapters.

In analyzing the triple bottom pattern, keep a close watch for declining tops. Think back to the double top formations. When the stock declined but was unable to decline as far as it previously did, it implied that selling pressure was drying up. Conversely, if the tops or columns of X's are making lower tops, it suggests that demand is drying up. These two clues make the chart more bullish or bearish, respectively. This will hold true with any chart pattern.

Keep in mind that other factors must be taken into consideration when evaluating a chart. We put it all together in the chapters ahead.

Bullish Catapult Formation

The bullish catapult (Figure 3.9) is simply a combination of the triple top and the double top. This pattern is a confidence builder. The bullish catapult comprises a triple top buy signal followed by a pullback producing a rising bottom. Following the pullback, the stock resumes the trend giving a double top buy signal. Take a look at the pattern in Figure 3.9. Notice the triple top buy signal followed by the pullback into a column of O's. Notice how the column produces a higher bottom. The resumption of trend completes the bullish catapult by giving a double top buy signal.

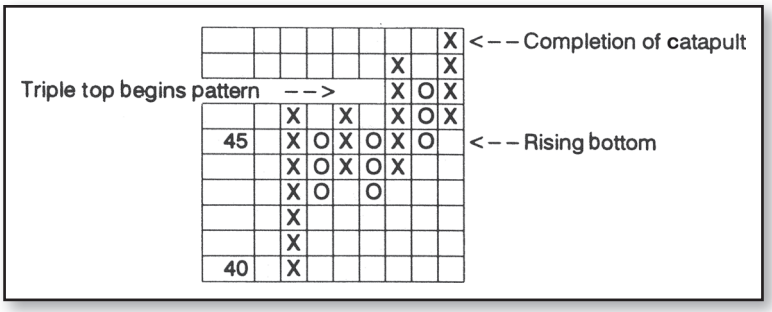


FIGURE 3.9 The Bullish Catapult Formation

Let's look at the bullish catapult in pieces to better understand what it is saying to us. The triple top is saying that the stock has a very high probability of rising in price, assuming the market is in a bullish mode. In fact, this type of pattern has a success probability of 87.5 percent in bull markets. The subsequent reversal producing a higher bottom suggests that supply is beginning to dry up or becoming a less significant factor. The resumption of trend and subsequent double top buy signal simply confirms the triple top. The bullish catapult is a confidence builder. This is one pattern that you can be more aggressive with when the overall markets are in a bullish mode, the underlying sector is in a bullish mode, and the fundamentals are superior in the stock.

The steps involved in stock selection resemble the steps involved in taking the trip from Virginia to New York City. Before you begin the trip, you need to gas the car up, check the oil, and check the water in the radiator. Then you must select the most direct route to New York (I-95 North). Gassing the car, checking the oil, and so on are similar to checking the fundamentals of the underlying stock. Selecting the proper interstate to embark on is similar to evaluating the technical (supply-and-demand) picture of the underlying stock. Many investors are diligent in doing the fundamental work on a stock they want to buy but ignore evaluating the probability of it rising in price. Buying a fundamentally sound stock that has just completed a chart pattern that suggests lower—not higher—prices is like making all the preparations for a trip to New York, then embarking south on Interstate 95 toward Florida. The idea is to stack as many odds in your favor before you begin the journey. There still isn't any guarantee. As much as people try to make investing a science, it remains an art.

In teaching this subject to grade school children, I have observed it takes only 30 minutes of instruction for them to make the right selection when evaluating bearish and bullish charts together. The beauty about teaching children is that you don't have to deprogram them. Adults have preconceived

ideas about how the market is supposed to work, mostly derived from watching TV programs about finance. All we are trying to ascertain with these chart patterns is whether supply or demand is in control of the underlying stock. If you go any farther than that, you've gone too far. Keep it simple. The law of supply and demand causes prices to change whether it's in the supermarket or the stock market.

Trading Tactics Using the Catapult

The bullish catapult is a confirmation pattern—the final double top that completes the bullish catapult simply confirms the previous triple top. It's a confirmation that demand is in control at this point in the stock's trend. The first part of the pattern is the basic triple top. Over the years we've found that buying on the pullback or reaction from breakouts offers a higher probability of success in the trade. Once a triple top has exceeded the previous column of X's and then pulls back, the potential for a bullish catapult exists. Investors might consider buying half their position on the three-box reversal from the triple top. This gives them a good entry point for the first portion of the position and gets them in close to their stop point. Let's talk about the stop for a second. At what point will investors have to stop out of the position if they are wrong in their assumption that the stock will rise? In this case, with the only information being the chart pattern, the only logical stop would be the triple bottom. At that level, the pattern would suggest that supply was in control. If the stock is selected using strong fundamentals, has strong relative strength, and is trading above the bullish support line, the probability of a failure in this pattern is low. Still, investors must consider what to do when things go wrong. There needs to be a plan of action if the trade begins to go sour. Remember, this is not an exact science, it's an art.

Once half the position is bought on the three-box reversal and the mental stop is in place, investors can begin to execute the plan to buy the other half of the position on the completion of the bullish catapult. Traders can then raise their stop to the new double bottom sell signal that is formed when the stock reverses back up to complete the bullish catapult. Long-term investors will keep their stop on the violation of the bullish support line, otherwise known as the trend line. In Figure 3.10, we would have to assume that supply had taken control if the stock violated the trend line and simultaneously gave a double bottom sell signal. The stop-loss point would come at the 42 level once the bullish catapult formation was complete. Just keep in mind that as long as a stock trades above the bullish support line, we

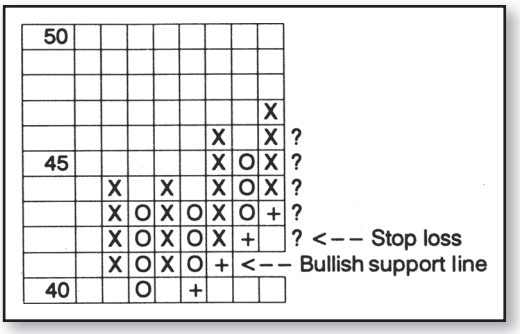


FIGURE 3.10 Knowing Where to Set the Stop

consider it bullish. Long-term investors will only stop out on violations of the trend line. Traders will be more apt than investors to take the sell signals above the trend line.

So far on our order entry using the bullish catapult, we have bought one half the intended position on the pullback to 43 and entered a mental stop-loss point at 40. Now, for the second half of our intended position, we enter an order called a "good 'til canceled" (GTC) order. The GTC order simply allows you to select a price you are willing to pay for your stock, and your order remains on the specialist's books until the stock reaches that price. In this case, you would place an order to buy the remainder of your position at 47, the level where the bullish catapult formation will be completed.

You can now see where you bought the second half of your intended position. Notice how the stop has risen now to the new double bottom sell signal that has formed at 42. This new stop allows us to protect profits should supply suddenly take control of the stock. It is important that long-term investors use only the trend line to stop out of a position. Traders are much shorter term in nature and may select a percentage of the entry price as their stop. A. W. Cohen, one of the pioneers in this method of analysis, always suggested that investors risk no more than 10 percent in a stock. In today's more volatile markets, a 10 percent decline can happen fast. We find it more useful to carefully select our entry point and then give the stock some room to perform.

By looking at the bullish catapult formation, you can see many other combinations of entry points that you can use (see Figure 3.11). The key is that you have an organized and logical guide to assist you in finding entry and exit points when investing. No other charts that I am aware of can do this. The Point and Figure charts are, without a doubt, the best and most accurate guides an investor can use.

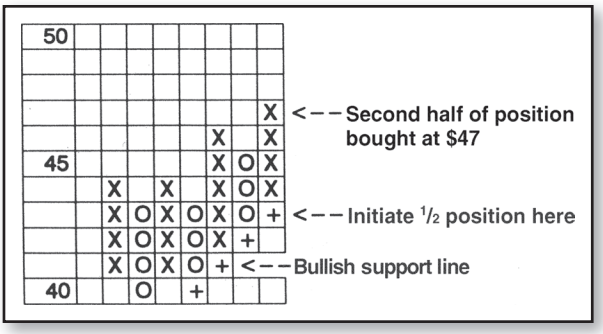


FIGURE 3.11 Trading with the Bullish Catapult Formation

Bearish Catapult Formation

The bearish catapult formation can be interpreted exactly opposite the bullish catapult formation and is particularly useful in timing short sales. Entry and exit points would be selected the same way we did with the bullish catapult. Stop points are particularly important in selling short. The risks in short selling are theoretically unlimited. In reality, that is not probable, but I have seen situations where stocks received buyout offers that significantly increased their price. The problem with being short in these unusual situations is that the stock stops trading and opens at a higher price without anyone's being able to get out. These situations, however, are few and far between. It is very important to plan your entry point so you have a palatable stop price. A short seller might plan to sell half his intended position short on the first reversal back up in the chart pattern following the triple bottom sell signal. This will allow him to initiate the short relatively close to his stop point. Trend lines are even more important in short selling. The second half of his intended short position can be initiated when the stock reverses back down and completes the bearish catapult formation. Let's look at Figure 3.12.

You can see that this pattern is the exact opposite of the bullish catapult. Watch carefully for this pattern, as it clearly suggests lower prices in the underlying stock. Whether you understood Point and Figure charting or not, if you looked at two fundamentally sound stocks, both in the same group, one with a bearish catapult formation and one with a bullish catapult formation, it wouldn't take long for you to determine which stock you wanted to buy.

These same patterns are used to assist the investor in using the options market. I have always looked at puts or calls as being surrogates for the underlying stock. We use only in-the-money calls or puts because the delta (the amount the option will move in relation to a 1-point move in the underlying

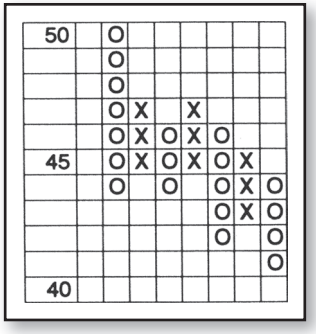


FIGURE 3.12 The Bearish Catapult Formation

stock) is much closer to 1 for 1. If an in-the-money long call is used as a substitute for buying the underlying stock, then use the same entry and exit points that you would use if you were buying the underlying stock. The same goes for put purchases as substitutes for outright short selling. Another school of thought in options buying is to let the premium be your stop. If you use this strategy, never buy more options than you would otherwise have an appetite for round lots of the underlying stock, either long or short. If you are normally a 300-share buyer, then buy only three options. If you allow the premium to be your stop, then you have the staying power to hang in the position until expiration. I have seen numerous times where a stock declines substantially early in the trade only to come back strong a few months later. We could devote a whole book to this subject, but let it suffice for now that Point and Figure chart patterns can be very useful in assisting the investor with entry and exit points for options trading as well as stock trading.

Triangle Formation

The triangle formation is a combination of patterns we have seen before. The key to understanding chart patterns is being able to sit down with a pencil and paper and write down exactly what you see. Don't look at the whole pattern and try to decipher it. Evaluate the parts making up the pattern, and you will then understand the pattern in total. In Figure 3.13, you can readily see the rising bottoms and lower tops in the pattern. To qualify as a triangle, the pattern must have five vertical columns. The rising bottoms suggest that supply is drying up. You will also see the series of lower tops. The lower tops suggest that demand is becoming less of a factor in driving the stock. In our tennis analogy, the two players are getting more tired after each set, and the players have equal ability. Eventually, something will have

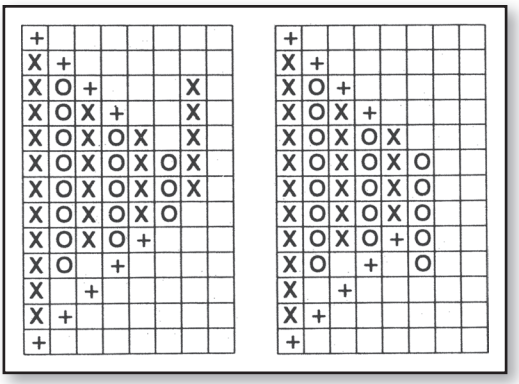


FIGURE 3.13 The Triangle Formations

to give. One player or the other will get a second wind or begin to take the upper hand. It is at this point that we want to make a commitment in the underlying stock. There is nothing to do but wait and watch the match. If the pattern resolves itself on the upside, it will give a double top buy signal. The double top buy signal simply suggests that demand has won the match and the probability is higher prices in the stock. Now look at the bearish triangle in Figure 3.13. Notice how the match is won by supply. The double bottom sell signal suggests that the probability is lower prices in the stock. These patterns are simply road maps. They are not crystal balls.

There are a couple of other things that we want to point out about the triangle pattern. First, usually a stock in an uptrend will resolve the triangle on the upside (i.e., a bullish triangle). Similarly, a stock in a downtrend will usually resolve the triangle on the downside (i.e., a bearish triangle). Second, it is usually feast or famine with the triangle pattern. We will either see very few triangles forming, or we will see a whole host of them developing. Most of the time when we see quite a few triangles forming, it is during a choppy or sideways market, and supply and demand are battling it out for control. Third, breakouts from the triangle pattern typically result in quick, explosive moves, so it behooves you to be ready to act when the signal is given. Look at the chart pattern in Figure 3.14. The stock in this graphic is forming a triangle pattern right at the bullish support line. A move to 55 would break a double top and complete the bullish triangle pattern and long positions could be taken. However, if the stock hit 49, it would not only complete a bearish triangle but also violate the bullish support line. The stock could be shorted at 49. On our Internet site, we have premade reports that allow you to see the charts of all stocks breaking out of a bullish triangle, bearish triangle, and all the other different patterns.

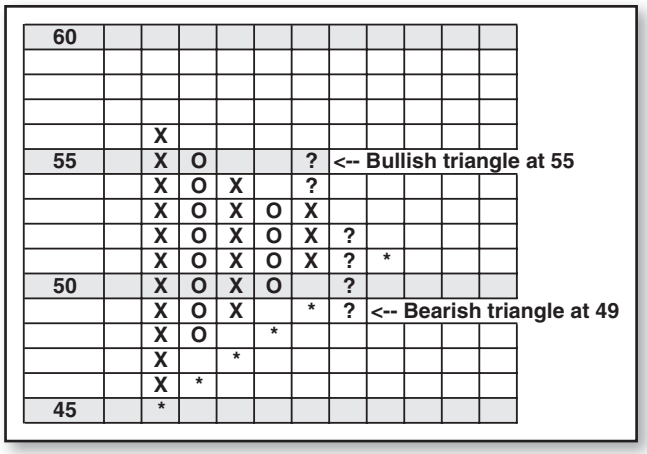


FIGURE 3.14 Planning the Trade with a Triangle Pattern

Variations of the Triple Top

I usually call this pattern the diagonal triple top, but I hesitate to use the name because it sounds too difficult. Possibly a better name would be a bullish signal. I have said many times if investing gets too difficult for a seventh grader to understand, the system is needlessly complex. It is important to keep it simple, especially in technical analysis. We don't usually use this pattern as a triple top, but older publications classify it as one. This variation is simply two double top buy signals, one right after the other. This is the sign of a good, strong uptrend. A stock in a strong uptrend will produce rising bottoms and rising tops, and that is exactly what this pattern demonstrates. Notice in Figure 3.15 that you simply have two consecutive double tops with rising bottoms.

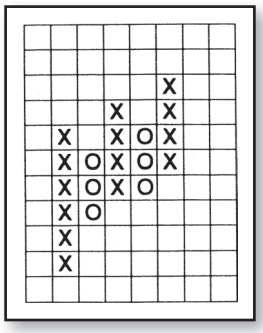


FIGURE 3.15 The Diagonal Triple Top/Bullish Signal

Variations on the Triple Bottom

This pattern is simply the reverse of the diagonal triple top or bullish signal. We can simply call this the bearish signal. It has a series of lower tops followed by lower bottoms. Just looking at Figure 3.16 suggests that supply is in control. This is all you want your chart pattern to alert you to. Another way to look at it is two consecutive double bottom sell signals. We almost never evaluate this pattern as a triple bottom, although A. W. Cohen clearly classifies it as such.

Spread Triple Top and Bottom

This pattern is simply a triple top that takes a little more space on the chart to complete. Notice the gaps between the tops in Figure 3.17. This is where the spread comes in. The normal triple top has no gaps between the tops. The same philosophy applies in this pattern as in the triple top. In each case, the stock rises to a certain price level and is repelled two times. The third attempt at that price is successful by the stock's moving through the level shown by a column of X's exceeding the point of resistance. Since the stock was repelled twice at that same level, there are apparently sell orders there. The reason is not important. What is important is that there are sellers at that particular level. The only way to know if demand can overtake the selling pressure is to see how the stock negotiates the level again. Simply stated, if the stock is repelled again at this level of resistance, the sellers are still there. You need not know any more. If the stock exceeds that level, then demand has overcome the supply that previously caused it to reverse. This is why we always wait for a particular level to be exceeded before we make a long or short commitment in the stock.

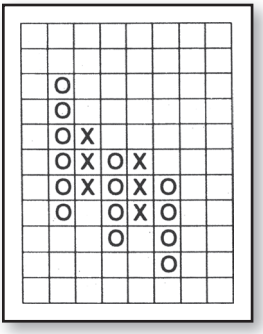


FIGURE 3.16 The Diagonal Triple Bottom/Bearish Signal

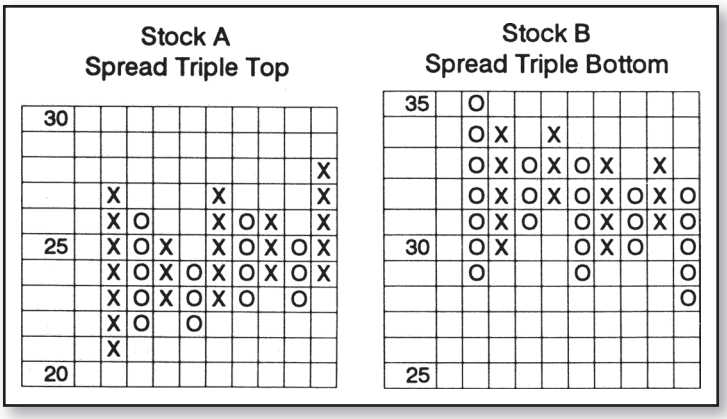


FIGURE 3.17 The Spread Triple Top and Bottom Formations

In the 1980s, we typically just bought or sold the breakouts. Starting in the 1990s, we found out that it was best to buy on the pullbacks. For most of the 1980s, stocks went up. From the 1990s forward to 2000, stocks continued their rise. Then, in March 2000, something major happened. The technical balance sheet on the Nasdaq turned decidedly negative, while the technical balance sheet on the New York Stock Exchange (NYSE) turned positive—one door of opportunity closes while another one opens. For the rest of 2000 to the third quarter of 2002, tech stocks were virtually decimated. During that time, though, there was money to be made in other sectors like utilities, builders, real estate investment trusts (REITs), and health care, just to name a few. In 2008, everything became correlated and there was nowhere to hide. Our Dynamic Asset Allocation indicator suggested that we not own any stocks that year. We oscillated between the following asset classes: fixed income, commodities, currencies, and money market, and that was it for the year. Much of the year was spent in cash. This is why the top-down approach is best. Sometimes you should just have the defensive team on the field and not try to run any plays. It was a year not many investors had experienced before—that is, unless you lived through the crash of 1929. Since 2008, it's been tough going. However, there have been good investments in different asset classes. We are now 4½ years past 2008, and the economic troubles of Europe continue to plague us. U.S. stocks have been the right asset class to be in as European money has been searching for a place to hide and the only logical place is the United States. This will change as they get their finances in order. Interest rates are now at zero, so there is nothing to be gained from holding money in the bank.

Notice that in the two patterns shown in Figure 3.17, the stocks are trading at the same price. Consider that both stocks are fundamentally sound and each is being recommended by a major firm on Wall Street. Both stocks are in the same industry group and pay about the same dividend. You have studied the fundamentals of the two stocks and are now trying to determine which stock to buy. It's the moment of truth. Which stock do you select?

Without the chart patterns shown here, you would be in a quandary. Looking at the fundamental data alone, both stocks are equal; therefore, both stocks should do about as well in the future. Not so. If you had the benefit of evaluating the Point and Figure charts in Figure 3.17, the selection process would become much easier. With the information I have just given you, which stock do you select? It doesn't take an in-depth understanding of this method to determine stock A is in an uptrend with the probability of higher prices and stock B is in a downtrend with lower prices likely.

This simple exercise shows why charts are so important and why you can achieve the best results in the market when you use both fundamental and technical analysis. The fundamental work answers the question "what," and the technical side of the equation answers the question "when." Both are equally important. The first question, "what," is easily answered because fundamental research is everywhere on Wall Street and the Internet. Anyone doing business with a broker of a major firm on Wall Street, either through their online system or direct through a broker, has access to all the fundamental ideas that the firm produces along with its related research. Technical analysis is much harder to come by, but with the information in this book, you will be perfectly capable of performing that task yourself.

The market and sector represent 75 percent of the risk in any particular stock. The problem most investors have is that they concentrate 75 percent of their effort on evaluating the fundamentals. It is extremely important to buy stocks when you are in possession of the football (the market is in a bullish mode). We cover the market indicators in later chapters. We started this book with the discussion on individual chart patterns because these patterns make up the market indicators.

Once again, stack as many odds in your favor as possible before you make a commitment in the stock market. I don't know how many times acquaintances have come up to me and asked what I think about a stock tip they just got from a friend. They usually say it's a very reliable source. My answer is always the same: If it's inside information, you won't have it. The second you have it, it's outside information, and those who are really in the know have already acted on it. In almost every case, you can look back on the Point and Figure

chart and see clearly where the insiders were operating. Once you get the handle on this method, which has remained true to form for over 120 years, you will see why the Point and Figure chart is as good as inside information. We have a four-step game plan that we follow, and this is the sequence of events you should follow before you make a stock commitment. Step 1 is to evaluate the overall market; step 2 is to evaluate the sector you are investing in; step 3 is to answer the question of "what to buy" (the fundamentals); and, finally, step 4 encompasses stock selection, which answers the question of "when to buy."

Bullish Shakeout Formation

This is one of my favorite patterns. We keep a strong eye out for this pattern because it has a high degree of reliability. The shakeout is a relatively new pattern; we've only been watching this one for the past 25 years or so, but we have found it very useful in real-life application. It is called the shakeout because the pattern easily deceives investors when the sell signal is given.

There is a big difference between the chartist and the technician: Many chartists operate on chart patterns alone without any other input, whereas technicians use other indicators to assist them in evaluating stocks. Don't forget there are other considerations besides just the chart pattern when making a stock selection. The chart patterns should be used to determine whether supply or demand is in control of the underlying investment vehicle. Because so much risk is associated with the market and sector, it is imperative to thoroughly evaluate both factors before considering the underlying stock. If you are buying stocks in a down market, you will surely lose money. If you are selling stocks short in an up market, you will surely lose money. We want to drive home this point because the shakeout pattern works best in strong bull markets. We have not had much success, as you might imagine, using this pattern in a bearish market. With that caveat, let's look at the six attributes of a shakeout formation:

1. The stock and market should be in a strong uptrend.
2. The stock should be trading above the bullish support line.
3. The stock must rise to a level where it forms two tops at the same price. Note this says "forms" two tops, not breaking the double top.
4. The subsequent reversal of the stock from these two tops must give a double bottom sell signal.
5. This sell signal should be the first in this uptrend.
6. The relative strength chart must be on a buy signal or at least in a column of X's.

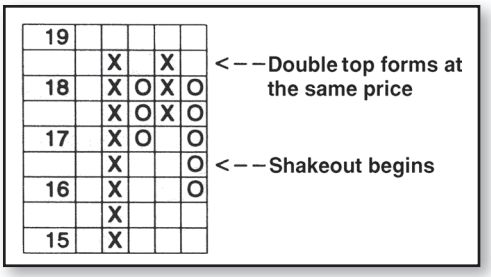


FIGURE 3.18 The Shakeout Formation

Sounds like a lot, doesn't it? It's not really. In our day-to-day operations, we fudge these parameters a little, but in general the shakeout has these characteristics. Remember, the whole idea in using chart patterns is to determine whether supply or demand is in control. Don't forget that, and don't read too much into it because you will usually overthink the position, which in turn results in losses. The best machine is the one with the fewest moving parts.

The shakeout pattern shown in Figure 3.18 is also great for trading. Since the stock must be in a strong uptrend to qualify for the shakeout pattern, you very well may already have an existing position in the stock. The shakeout can provide you with an opportunity to add to that strong position or if you aren't already long, it can provide an opportunity to get in a dip.

The shakeout begins by giving the double bottom sell signal. We never know what level the sell signal will carry the stock down to so our action point for entry into this stock is on the first three-box reversal back up the chart (see Figure 3.19). This is the only point where we know demand is back in control. Once the stock reverses back up into a column of X's, the position can be taken.

The next consideration is what to do if things go wrong. Where is the stop-loss point? We always use the double bottom that is formed when the stock reverses back up as our exit point. Normally, this is 4 points' risk. Remember that the reliability of this pattern, and any other bullish pattern, diminishes when the overall market is in a bearish mode and your stop-loss

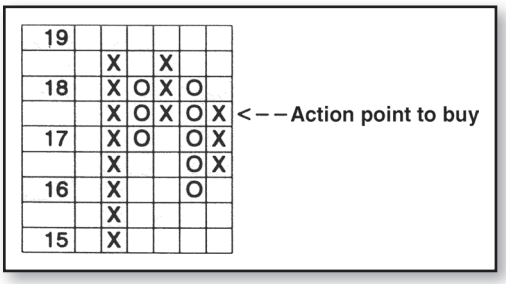


FIGURE 3.19 Action Point on the Shakeout

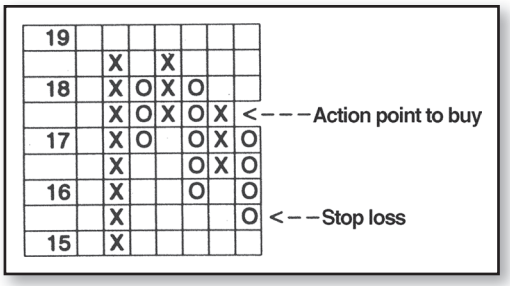


FIGURE 3.20 Stop Loss on the Shakeout

point has a higher probability of being hit. Look at Figure 3.20 to see how entry and exit points are established. If the trade was established at the action point, and the stock immediately reversed, the stop point would be the first sell signal the stock gives. The stop is at 15½.

Long Tail Down

This is one of our favorite bottom-fishing patterns. To qualify for a long tail down, the stock must have declined 20 or more boxes without a reversal. After such a decline, the first reversal up usually provides a good trading opportunity. We used to see the 20-box-down movement only in stocks that were already in strong downtrends, and that move was the final capitulation. However, with increased volatility in stocks, like technology in 2000, some of the oil and nonferrous metals stocks in 2005–2006, we have now seen stocks in uptrends pull back 20 boxes—just above strong support areas. Of course, this begs the question, "Do you really have the risk tolerance to buy a stock that can move 20 points in one day?" Nonetheless, this pattern can be a good trading pattern.

I remember a time when we thought the pattern was infallible. It had worked for a string of trades, so we decided to pound the table on the next one we came across. It seems that Murphy is always hanging around when you alert the world to a particularly lucrative situation (you know Murphy's Law: If anything can go wrong, it will). One day we came across a long tail down in Apple Computer. Apple is a great trading stock as the volatility is high and it seems everyone has played it at some time or another. Apple had just gone through one of these 20-box-down patterns. We knew we had a winner. This time we pounded the table with the recommendation to buy on the first three-box reversal back up the chart. I mean we pounded the table. When the reversal came, I think most of our customers took the trade, and many of our customers are large institutions. You guessed it—the stock struggled up a point or so and then caved in. It was the first one in

many moons that didn't work. It always seems to work out like that. The one you get everyone to buy fakes you out. Apple did it again in 2000. The stock came with less-than-expected earnings and "bang" down 50 percent and over 20 boxes. The stock reversed up a few days, only to reverse down again. It did that two more times. But in 2005, Chicken Little had his revenge, and that stock became as hot as a firecracker. Things always seem to come full circle.

On balance, this is a good trading pattern. The idea is simple. When a stock has declined 20 boxes or more, you take the first three-box reversal back up the chart as your action point. The stop-loss point is the double bottom sell signal that is set up when the stock reverses up into a column of X's. The longer it takes for the stock to decline 20 boxes, the less reliable the pattern is. This is for trading purposes only and not for investors. A stock that has declined 20 boxes or more usually has something wrong with the fundamentals. One of the better ways to play the trade is through the call market. This will give you staying power to expiration, and you need not worry about your stop point being hit. If the stock rises from your entry point, you can raise your stop to each subsequent sell signal that forms. This will allow you to get the full ride if no sell signals are given. It also prevents you from taking a profit too quickly. Always allow your profits to run as much as possible and take as much subjectivity out of the equation as possible. Figure 3.21 shows the long tail down pattern.

The same philosophy can be applied to a long run of X's up but with a much smaller degree of success. As a stock rises, the fundamentals are coming to fruition and there are no dissatisfied investors. For this reason, we just don't see enough selling pressure to warrant a trading commitment in a stock that rises 20 boxes without a reversal. Pullbacks in strong stocks like these appear as opportunities to buy, not to sell, and can easily generate demand. Remember, there are no dissatisfied investors at tops. Still, the very nimble can take advantage of it. I usually don't. I am much more apt to attempt a trade on a 20-box-down move. However, the three-box reversal down from a run up of 20 boxes or more can be very useful in providing a stop-loss point for traders to take profits or a place for an investor to take partial positions off the table.

Broadening Top Formation

The broadening top formation is simply a variation on the shakeout formation. The primary difference between the two is that the broadening top

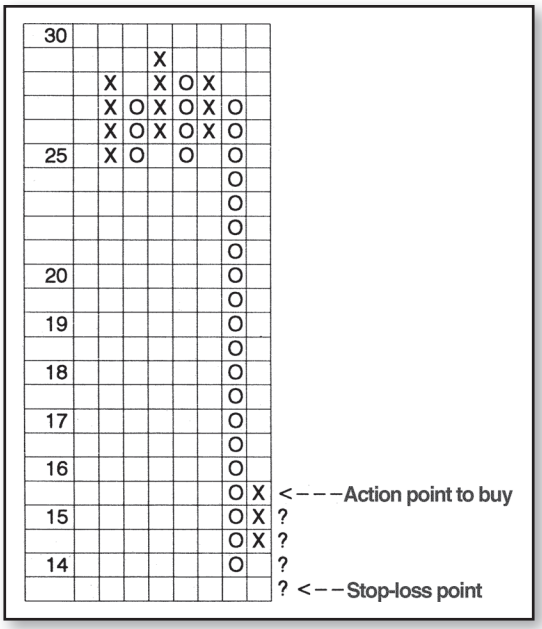


FIGURE 3.21 The Long Tail Down

gives a buy signal prior to the sell signal's being given. Let's look back for a moment. If you don't have the shakeout firmly in mind, go back and look at the pattern (Figures 3.18 through 3.20). You will see that the underlying stock has risen up to a certain level two times but was unable to exceed that level the second time. The stock in essence formed a double top. Subsequently, it reversed and gave that first sell signal in the uptrend. In the case of the broadening top formation, the stock exceeds that previous top the stock made. In other words, it gives a double top buy signal. The subsequent reversal gives the sell signal. The combination of the higher top and lower bottom has the appearance of broadening the pattern. To complete the pattern, the stock then reverses back up the chart to give another double top buy signal (see Figure 3.22). If you look at those two consecutive double tops, you will see the same pattern as the diagonal triple top described in the section variations on the triple top; the only difference is the sell signal in the pattern. I always think in terms of economics when I evaluate a Point and Figure chart. What is it telling me in economic terms? The forces that cause price changes in anything are supply and demand. Since these patterns are nothing more than a logical, organized method of recording supply and demand, the answer must lie in basic economic principles.

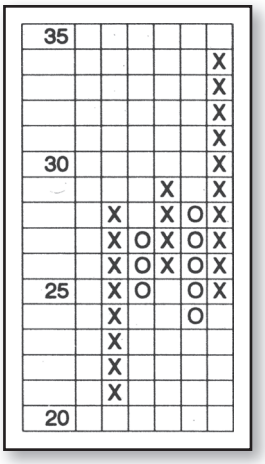


FIGURE 3.22 The Broadening Top Formation

The broadening top formation usually takes place after a stock has run up nicely. What the formation is basically saying is that supply and demand had equal power at the point the pattern was broadening out. The double top buy signal was suggesting that demand was still in control. The double bottom was suggesting that supply had taken the helm and the uptrend was in question. The subsequent buy signal clearly showed that demand was still in control and that the stock had found enough sponsorship to move higher. When that double bottom sell signal is given, it alerts us to take a closer look at relative strength and the broad market and sector indicators before taking action. If all those things are positive, we will likely give the stock a little latitude.

Bearish Signal Reversed

We almost always play this pattern. It is seldom seen, but when it is, you should pay close attention. Investors can detect the pattern while it forms, which allows them to plan their trade. Often, we will show the pattern and discuss the underlying stock in our report days before the pattern is complete. In this great chess game, it helps tremendously to be able to plan your moves. To qualify for the bearish signal reversed, the pattern must have seven columns in it. Each column of X's must be lower than the one before and each column of O's must carry lower than the one prior to it. In the tennis match analogy, the player symbolized by X is underperforming the player symbolized by O. You can easily see this. Remember, keep it simple. Look

at the pattern in the context of a tennis match where each column in the pattern represents a set within the match. You can see that when a column of O's takes control of a set, it carries lower than the previous column. Action like this demonstrates that supply is getting stronger. When the column of X's takes control, it is unable to carry up as high as it previously did. By evaluating a pattern in this context, you can easily see that supply is stronger than demand and the probability is lower prices. This action is what we characterize as the bearish signal. Now let's look at the reversed part of the pattern. The reversal up into a column of X's with the subsequent double top buy signal shows a change in this supply-and-demand relationship. Something has happened to cause demand not only to win a set by reversing up but to win the match by exceeding a previous top and thus giving a buy signal. What makes this buy signal more important is that it exceeds a series of lower tops. In essence, it breaks the spell. Figure 3.23 shows this pattern.

The reversal is often caused by some sort of news that is not widely disseminated or understood by Wall Street. Insiders are usually operating at this point. Ask yourself a question. Why would such a negative pattern that is being controlled by supply change abruptly midstream? Is it possible that an upcoming earnings report is likely to be better than Wall Street expects? Usually, there is some fundamental change in the stock that is not widely known. Like the triangle pattern, the results from this pattern usually happen in a quick, explosive move.

Bullish Signal Reversed

This pattern is the reverse of the bearish signal reversed. This pattern shows seven columns of rising bottoms and rising tops—the exact opposite of the bearish cousin (see Figure 3.24). When the last top is made in the seventh column, the stock reverses and without a period of distribution declines to

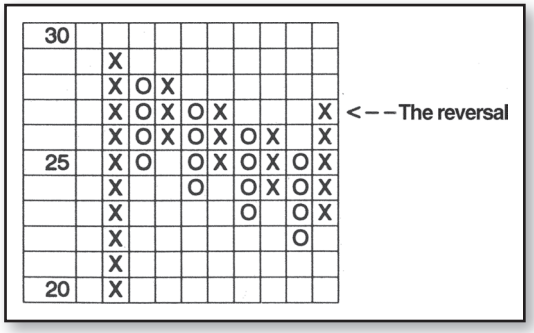


FIGURE 3.23 The Bearish Signal Reversed

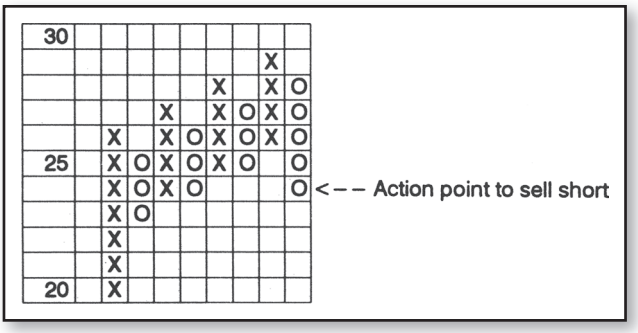


FIGURE 3.24 The Bullish Signal Reversed

give a double bottom sell signal as well as break the series of rising bottoms. We have seen this happen in drug companies where Food and Drug Administration (FDA) approval of a particular drug was not forthcoming. Someone usually knows of this before Wall Street does. There are many other reasons for the quick reversal. It is usually brought on by insiders selling. When I say insiders, I don't necessarily mean the management of the company. What I mean is simply any investor who has information that is not widely known on Wall Street. I can truly say that I have never made money on so-called inside information. When anyone calls you with a tip or posts one on an Internet chat board, the whole street usually knows it. Whenever someone gives you a tip, ask yourself what the person had to gain from telling you. In the final analysis, you will find that frequently the reason for clueing you in was that the tipster had stock to sell. This type of action runs rampant on the Internet. So be very careful what chat rooms you participate in. Most investors are providing free information that serves their investment objectives, not yours. Remember, there are no disinterested parties when it comes to investing. Everyone has an ax to grind some way or another. I get e-mails all the time from professional or individual clients who point out the positive fundamentals and technicals of a particular stock. Of course, they are just giving me this information to be nice, right? Wrong! In most cases, they are hoping I will recommend it in our report in the hopes we will run the stock up for them. I've had people ask me to mention a particular stock on my next CNBC appearance. I would never do that, but it shows you there are no disinterested parties on Wall Street. That can't happen today, as I gave up appearing on national TV and we at Dorsey, Wright decided to do our own media. It's much more fun that way and we can now say what we want, when we want, and for as long as we wish. It's great to take control of your own media.

I recently saw an interview with a well-known money manager. The interviewer asked the manager for some of his best picks (this actually happens all the time on TV), and he generously named some stocks that he thought were great values at current prices. I looked in the back section of the paper for the list of stocks that the money manager's mutual funds were buying and selling and, lo and behold, his fund was selling a stock he had just recommended for purchase. If this analyst were buying the stock, why would he publish it? So investors could compete with him in the market and possibly drive the price up? Not likely. What is likely is that he had bought the stock earlier at much better prices and was more interested in selling it. Be wary of tips, especially at cocktail parties, Internet chat rooms and blogs. Those giving the tips usually have a vested interest. Get this. I was talking to a person who worked at a marina in Florida. We often chat about the market. He told me that he worked part time putting tips out in chat rooms. These were tips from boiler room, hype brokerages. This guy knew nothing about the market, nor was he an analyst, he just hyped what they told him to hype and they paid him for it. Remember what I said, there are no disinterested parties on Wall Street or Main Street. It's all about money, plain and simple. Voltaire summed it up best when he said, "When it is a question of money, everybody is of the same religion."

Before we leave the bullish signal reversed, let's look at Figure 3.24 and discuss the pattern using the tennis match analogy. The rising tops show that demand is in control of the match. Each time the X wins a set (rises in a column), it does so more convincingly by exceeding the level it previously hit. Each time the O wins a set (declines in a column), it does so less convincingly as it is unable to decline as low as it previously did. Then, without the stock's moving back and forth at the top (distribution), it declines in a straight column to give the sell signal and break the series of rising bottoms. In terms of economics, supply has taken control of the stock at 24. This is the point where you could enter a short position, especially if the stock were also violating the bullish support line. It would also be a point at which, if you were long, you should begin to examine that stock closer to determine what types of defensive strategies you should take. We could go through all kinds of examples of stops, but in the real world of investing, it just isn't cut and dried. Many factors come into the equation, not the least of which is the investor's temperament. In most cases, long-term investors will use only the trend lines as stops. Traders have different problems that generally surround trading capital preservation. Watch for this pattern. It won't show up often, but when it does, take action.

You know, one of the most asked questions I get is, "Have you got any back-testing done on this method of analysis?" My answer is yes. If you look in the first edition of this book, you will see a study done by Purdue University on the probabilities associated with the chart patterns we use. However, I have chosen not to use them in the second, third, or this edition because it suggests this method is a science not an art. You are the most important part of the method. Yes, you! Without you—the well-educated and experienced captain of this ship—it will drift aimlessly. Like anything else in life, the more you practice and use the method, the better you will become with it. I am starting a family office to run separately from DWA. I have asked my daughter Samantha to join me. After a few months of deliberation, she has decided to do it. Naturally, the first thing she must learn is everything this book discusses. So she is now charting 30 stocks a day by hand and doing relative strength drills each week. She is keeping me young. The following article explains exactly what it takes to become world class at something.

Are You Color Blind? Flash of Genius

I was cleaning up my desk to start out the new year with a clean desk and I came across an article entitled "Flash of Genius" from *Forbes* (November 16, 1998), along with some of my commentary. What caught my eye was the sentence, "We need to pay much more explicit attention to teaching pattern recognition." This comment was made by Professor Herbert Simon. The article went on to say, "Simon won a Nobel Prize in Economics in 1978 for theories of decision making that turn on the nature of human expertise. His central finding was that pattern recognition is critical. The more relevant patterns at your disposal, the better your decisions will be." I found it quite interesting when he discussed chess mastery. Most would think that mastering the game of chess relates to analysis, but Dr. Simon suggests that isn't the case. Success in chess relates to pattern recognition. I can picture Bobby Fischer playing Garry Kasparov of Russia in a chess match. Each is seeing patterns on the chessboard just as we would see patterns on a stock chart or a bullish percent chart. It's like a color-blindness test. Have you ever taken one in a doctor's office? Most people have. The patient looks at a card with colored spots on it. The person who is not color-blind can, without difficulty, see the number within the dots. Those who are color-blind cannot. The craftsmen in Point and Figures can see patterns that the uninitiated will never see, and this ability shifts them up to a much higher plane compared to other professionals

in the business. By understanding these patterns, whether on a chessboard or the big board, the initiated have the confidence to act rather than react.

"What makes a good doctor, lawyer or stock picker?" Simon asks. It all relates to pattern recognition. It relates to experience as well. "Mozart composed for 14 years before he wrote any music you'd regard as world class, you can tell juvenile Mozart from 18 year old Mozart." He suggests it's the same in all fields. "Bobby Fischer got to grand master title in chess in just under 10 years, and so did the Polgar girl. Brain power matters, but so does experience." He goes on to suggest that even your doctor has probably diagnosed your problem before you finish telling him all the symptoms. We at DWA often know the answer to portfolio questions asked by our broker clients before they finish illuminating the problem.

There are other patterns we use on a daily basis, for example, clouds. I am ever fascinated with weather. Not only weather but how weather affects business cycles. But think of this from an article entitled "Using Cloud Patterns to Predict Weather Fronts" by K. M. Simpson (July 29, 2008; http://voices.yahoo.com/using-cloud-patterns-predict-weather-fronts-1716617.html):

> The day starts out very warm and sunny with a cool breeze. It seems to be a great day to head outdoors! The clouds are very high and look like they could be thin feathers floating in the sky. You pack your bags and head out to the lake or for a day's hike. After several hours, the temperature is still very warm and the breeze is picking up its speed. You're still thinking about how perfect the weather is today. The clouds have started to come together. They look like big fluffy cotton balls dotting the sky. You continue your outdoor activities without a second thought. Soon, the cotton ball–like clouds start to stack on top of each other like a cone of cotton candy and begin to turn several shades of gray the lower they are. A far-off rumble can be heard. You ignore the sound and continue your activity. Before you know it, the sky above you is very dark with heavy clouds, the thunder is rumbling close by, and drops of rain have spoiled your outdoor fun! You now ask yourself how the weather could change so quickly without warning. Knowing what to look for can prepare you for the unexpected weather to come!"

Change these words around and you could adapt this to the stock market. Knowing what to look for can prepare you for the unexpected changes in the markets.

What Does It Take to Do World-Class Work?

No matter what profession you are in, there are those who are world class and those who are other than world class. In the "Flash of Genius" article discussed earlier, Professor Herbert Simon explains, "It takes at least ten years of hard work—say, 40 hours a week for 50 weeks a year—to begin to do world class work. We found it takes eight seconds to learn a pattern for a day, and quite a lot longer to learn it permanently. That takes you to the million-pattern estimate, if you allow for certain inefficiencies in learning and also for forgetting." This is why there are relatively few professionals in the investment business who could be called world class. The term we use for it is *craftsman.* How long do you think it took a cobbler in the seventeenth century to learn his craft? How about a cooper? I surmise that it would have taken about 10 years. Those who have reached world-class level have seen approximately 1 million patterns. This is exactly why it takes so long to become world class in the investment business. So many professionals jump from one thing to the next—they never take the time to do one thing well. To be world class, you must choose something to become a craftsman in. One of our analysts, Susan Morrison, calculated that during the 10-year time span when we charted by hand, about 400 stocks per day for 50 weeks a year, she had seen about 1 million stock charts. This is why she has such insight into the Point and Figure chart patterns of stocks, sectors, and the market. The rest of the analysts at DWA have similar experience. I am frequently asked, "What will happen when everyone is doing Point and Figure analysis?" My response has always been that to become truly good at it, one must take years of study, and most people do not have the time or the inclination to become a craftsman at this method of analysis. Only a select few will go the distance. A method becomes self-fulfilling when investors follow a "guru" (e.g., Joe Granville in years past) and simply do what he tells them to do until the inevitable happens. These investors are not interested in becoming well versed in the investment process. They simply want someone to tell them what to do.

Here is what normally happens. A broker reads our report and gravitates to the breakout reports. He looks at one symbol that says double top buy signal, buys that stock with no other analysis, and gets whacked. He then says this doesn't work and moves on to the next strategy. Every now and then, a broker will pick up my book *Point and Figure Charting* and read it. He will then begin to implement the strategy. Somewhere down the road, he will keep a few charts by hand himself. His feel for the subject then increases tremendously. He loves the new confidence he has. He continues to learn

and apply the method; years later, he looks back and can see a distinct difference between his abilities then and now. His journey has still much further to go to reach world class, but he is on the way. His client retention is now high as is his confidence. When he nears the tenth year, he is approaching world class, and the number of chart patterns he has viewed is approaching 1 million. He no longer needs to read the financial newspapers or watch the financial TV shows. Major statements made by Wall Street pundits have no effect on his thought process. He instinctively knows what to do in various market conditions. He is like a child who has totally memorized the multiplication tables, and now instinctively knows that 9 times 9 equals 81.

How many of you have been doing this for longer than five years and are now feeling comfortable with this investment process? You're on the road to world class. There's nothing like being world class at something. To get there takes determination, patience, and hard work. There are many other methods of analyzing the market that you might choose, from astrology to Gann angles. Whatever you choose, go the distance and become a world-class investor. You have only one life to live. Once you feel comfortable with your game plan for investing, the computer will do much of the work. In fact, it can do darn near all the work. I have to be honest here—much of what it takes to become world class is now in the implementation of the strategy once it has been developed. Here is what I mean. You have a pain in your upper right side. You are nauseous with this pain, and it generally comes and goes after you eat fatty or spicy food. A bloating sensation is also common. So what do you have? Google suggests it's a gallbladder problem that could result in laparoscopic surgery. With a few more lines of reading, you find out exactly how the operation is performed, how long it takes, when you would be able to go home, and what you would need to eat following the surgery. Okay, now what? There is a possibility you will have surgery and a high probability a robot will perform it. Yes, the doctor is watching but the robot performs the operation. Here is what I'm getting at. Let's say I am interested in a high-yield portfolio constructed of technically sound stocks in the Utility and Oil Service sectors. I could easily access the Dorsey, Wright online portfolio management system and search for stocks in those two groups that had bullish chart patterns and were in uptrends above the bullish support line, with positive relative strength and a risk-reward calculation of 2 to 1 minimum. Press the Get Portfolio button, and in less than a second the portfolio would appear. More on this in later chapters, but in a nutshell the computer is able to perform the function that would have taken hours, maybe days to create only a few years ago.

Stop-Loss Points

I saved this until last because everyone will decide for themselves what is the best method for stopping out losing positions. I remember reading some old manuscripts on Point and Figure, and they recommended a simple 8 percent stop if a position went against you. William O'Neil, one of the pioneers in technical analysis, also recommends 8 percent as the stop point in a stock position. I have a problem with percents. The problem is that a simple 8 percent stop may only suggest that the stock has taken the "pause that refreshes." Often, a small pullback of say 2.5 points (8 percent) on a $30 stock is a market-related pullback or what I call a healthy exhale. We like to use sell signals that develop on stocks we own as our "wake-up call." Traders who are quick on the trigger and need to preserve their trading capital should take every sell signal that develops. They, too, will be ready to go right back in on the next buy signal. This type of trading is not for most investors today. It's interesting to look at some charts of stocks and ask yourself the question: "What if I just held on to the stock until a sell signal was given?" You might be amazed how stocks trend for a very long time without giving the first sell signal. Often, it's hard to stay with stocks that continue to trend up because we inherently want to nail down profits while we have them. Just take some time and look at the charts and develop your plan. One "wake-up" call we use is when the relative strength (RS) chart gives a sell signal. In situations like this, we can easily set stop-loss levels once the RS chart gives a sell signal or reverses as these charts are long term in nature. Once this alert to negative RS is given, we can actually put the order in on the exchange, GTC, to sell if the stop point is hit. This way, you can hold the stock in the event it does not decline after the RS chart gives a sell signal. Remember, I said we must determine what to do if things go right and what to determine if things go wrong from the onset of the trade. Always work from a plan. There are no set rules for stop points. You will intuitively begin to know what works best for you as you develop your skills in this method of analysis. Try to take a longer-term approach to investing, and don't be too quick on the trigger.

CHAPTER 4

Foundations of Relative Strength

This is a chapter I want you to pay particular attention to. In my opinion, it is the most important. Naturally, everything in this book comes together to form a total methodology, but relative strength is the key. In *What Works on Wall Street* (New York: McGraw-Hill, 1998), Jim O'Shaughnessy found that RS was a factor in all 10 of the top-performing strategies (that he tested). He also found that the worst strategy in his testing was buying stocks with the worst RS. All of our listed products, like the PowerShares DWA Technical Leaders Portfolio (PDP), are rules based using relative strength (RS) as the engine of the selection process. Once the rules are established, the program runs itself. To give you an idea of how this rules-based process has done, PDP ranked in the top 1 percent of all funds in its category in 2012 (through August) and ranks in the top 8 percent of all funds in its category on a three-year basis (through August 2012), according to Morningstar data.

I use RS in every portfolio I construct. In fact, in most cases, I use RS only in portfolios I construct. You see, the computer can easily compare and contrast millions of charts overnight without my lifting a finger. The days of doing everything by hand is over. We have been able to teach the computer what we know. All the computer needs to understand is X's and O's. It is unlike a bar chart or candlestick chart where each is updated every day no matter how inconsequential the move happens to be. These charts are long and hard to read and thus do not lend themselves to portfolio management like Point and Figure charts do. Anyone

operating in the markets in 2013 has to begin thinking toward portfolio management and away from trading back and forth. After the meltdown in 2008, investors have taken a much more cautious approach to investing, and why not? Thirteen trillion dollars were lost during that period. Following the subsequent rally back up in 2009 and 2010, eight trillion was made back, leaving five trillion going up in smoke. As I write this, the most sought-after stocks are yield stocks, anything with a dividend or interest payment and lower volatility. Structured products with no-loss provisions like certificates of deposit (CDs) attached to an underlying stock or exchange-traded fund (ETF) have also become very popular in these difficult times. Naturally, when everyone moves in one direction, the market will move the other way, but even my portfolio has an overabundance of yield stocks coupled with what I think is a good chance for appreciation.

When you grasp these RS principles, you will gravitate to our matrix system, which is amazing. It gives you the capability of comparing large numbers of stocks and then ranking them from strongest to weakest based on their RS charts. Think of this for a second. What if you put a list of stocks your firm or your research determined were fundamentally sound into a matrix system at Dorsey, Wright & Associates (DWA) and within a few minutes you had a ranked list of those stocks from strongest to weakest on a relative strength basis. Would this not cut the time for research down to a few minutes?

Let's say you had 50 stocks you wanted to compare. Our computer system would, in a few minutes, calculate 2,500 charts, compare them, then rank them and present them in a very useable form called the matrix system. Think of the computer power that is required for this operation. You can access the results on your cell phone. You might want to select the top-ranked 5 and buy those stocks. You could then log on to your brokerage account from your cell phone and execute the orders, all while you were having a cup of coffee at Starbucks. Think this is farfetched? It's not! But for now, let's get back to the nuts and bolts of RS. It is essential that you understand this concept well, so when you have the computer do the work for you, it is nothing you couldn't do by hand yourself if you chose. Ever hear the one about the two guys camping in the woods and a bear appears? As one guy starts running, the other stops to put on his sneakers. "What are you doing?" the first guy yells out. "You'll never outrun the bear." His partner replies: "I don't have to. I just have to outrun you" (*Business Week,* May 5, 2003). This is RS at its best.

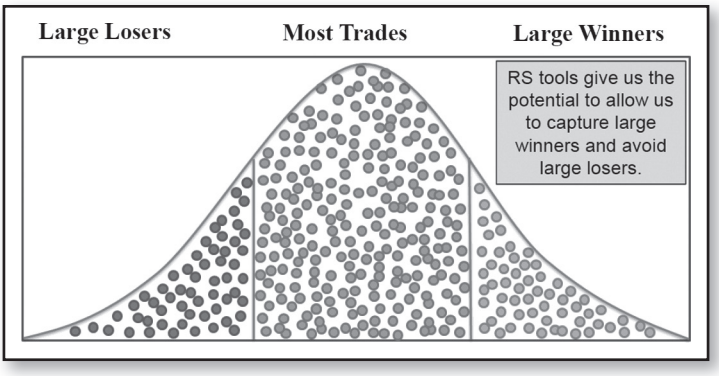


FIGURE 4.1 Relative Strength 80/20 Rule

The 80/20 Rule, or Pareto's Principle (named after Italian economist Vilfredo Pareto), is something we have all heard about. It basically means that in anything—management, wealth distribution, time spent on client relationships, and so on—a "few are vital" and "many are trivial." This same principle holds true with investment results—more specifically, that 20 percent of your trades are responsible for 80 percent of your profits (See Figure 4.1). Said another way, it is not the number of winning trades versus the number of losing trades that is most attributable to your investment success, but rather it is the size of your winners versus the size of your losers. The saying is true—size does matter! Oh, and guess what, the same principle applies to the gym. Twenty percent of your workout yields 80 percent of your gains. The rest is wasted time.

Given this proven, time-tested principle, it is imperative that you position yourself to capture the large winning trades. This is where RS comes into play. It is our contention that RS allows you to "catch the positive outliers" or big winners while helping you to avoid large losers.

At DWA, relative strength is a very important component or cornerstone of our research. Since the company's inception in 1987, RS has been part of our daily research; and yet over the past 20 years, the emphasis we place on RS has grown dramatically, as have the number of RS tools we have created to assist us in the stock selection process. We have found RS to be one of the most robust and adaptable methods of security analysis. Despite its truly being a very simplistic concept, RS has been proven time and time again to be a viable methodology for outperforming the market over time. This is the essence of RS—a way to measure outperformance.

Relative strength, as the name implies, measures how one security is doing compared to another, for example, how Microsoft is performing versus

the Standard & Poor's (S&P) 500 Index or how Ford is acting compared to General Motors. In essence, such a comparison allows you to determine which security is outperforming the other. The implication is that you invest in the vehicle that is outperforming the other, be it the market or another stock. (This speaks to the transferability of the RS concept—basically, you can do an RS calculation on anything! It can be applied on a stock-specific basis, with sector analysis, asset class evaluation, mutual funds, ETFs, commodities, fixed incomes, and even foreign countries.)

One way to visualize the RS concept is to picture two arms, locked in an arm-wrestling contest. You have all seen two people arm wrestle before. In fact, you have probably seen national arm-wrestling contests on TV. It is this type of battle between investment vehicles that we pay much attention to. Let's say you brought 10 contestants to an arm-wrestling tournament, each competing against one another. You will take the top five to the grand championships. You can't decide whom to bring until the match is over. We, in essence, put stocks, indexes, bonds, and the like in an arm-wrestling tournament to determine who has the strongest arm. As I watched the 2012 London Olympics, I kept thinking about RS when I watched the preliminary races to determine who will run in the finals. This is relative strength. Those with the best RS or speed will have a chance to compete for the gold. If you had the whole list of 100-meter runners, whom would you choose to be in your portfolio of runners? I surmise you would select those who were fast enough to qualify for the finals. Our tournament consists of mathematical computations to determine the winner, but the computations are nothing more than a seventh grader can perform by hand. Computers simply allow us to do these computations thousands of times in a very short time. Technology is amazing. In the end, RS steers you toward the outperformer and away from the underperformer and helps you to invest in, and stay with, that winner for as long as the RS chart suggests outperformance. For instance, Apple Computer has been a member of our PDP for years now. It has not yet suggested its RS has decreased enough to be replaced by another stock. You focus your buying on those securities exemplifying the strongest RS, and sell (or sell short) those vehicles that exhibit the weakest RS. Here is where the computer capacity we have today in 2013 differs so much from what we had 25 years ago. As I mentioned in Chapter 1, we started DWA with one computer, which was a Tandy 3000. Today, we use cloud computing. Instead of our computer systems physically expanding, they are contracting in size but increasing geometrically in power. For instance, for us to compare the S&P 500, each stock

against each other stock, just like the arm-wrestling contest mentioned earlier, we would have to create 250,000 charts, 500 × 500. When the comparison was completed, our system would then rank them in a matrix from best to worst. This is computer power at its best. This calculation would be virtually impossible only a few years ago. We would have had to shut down all other work being done on our database just to perform this calculation. Today, we can do it in a matter of minutes. Think for a second how important a calculation like this could be to a money manager or hedge fund manager who wanted to stick to the stocks with the best RS in the S&P 500 and avoid the worst.

Different Types of Relative Strength

We use two main types of RS charts when evaluating a specific stock. In both cases, the calculation is very simple, yet the results provide us with a ranking system. This is not unlike other areas of life, such as in the sports world, and in particular, college football. Each week during the college football season, we hear about the BCS (Bowl Championship Series), which tells us what team is considered to be the best in the nation. These rankings are based on strength of schedule (opponents) and how the team has performed each week—did they win or lose, and by how much? It's interesting how this RS concept permeates our daily lives. Even when you shop at the supermarket you are employing the concept of RS. I know that the RS of summer squash is low in the winter, and the RS of winter squash is low in the summer. *Consumer Reports* is a magazine that focuses on evaluating the RS of various products. We consult this magazine to determine how a certain stereo system functions versus another, or how a particular model of car ranks versus another. Although we use this concept of comparing one to another in our daily lives, very few even think of it when evaluating investments. Let's now take a detailed look at each of these methods of "ranking" a particular stock.

1. *RS versus S&P 500 Equal Weighted Index*. This is the more common and most widely used of our RS calculations. It measures how a stock is performing compared with the market in general. For this comparison, we use the S&P 500 Equal Weighted Index (SPXEWI). We often refer to this as the stock's market RS. The RS calculation is simply done by dividing the price of the stock by the price of the SPXEWI, then multiplying by 100. (We move the decimal point merely to have an easier number

to work with.) This number is then plotted on a Point and Figure chart, using the same charting principles discussed in earlier chapters. Okay, stop for a second. Let me backtrack for a moment. Just like plotting a Point and Figure chart for the trend of a stock, we use a number. This number is simply the price of the underlying stock. The RS chart is plotted the exact same way, but the number we use is derived by dividing something by something else. In this discussion, we are dividing the price of the underlying stock by the SPXEWI, resulting in a *number*. This number is then plotted on a Point and Figure chart just like we did when plotting the trend chart. We just get this number by dividing one thing by another instead of using the price of the underlying stock. It really is this simple. You know what? We even calculated an RS chart for Phil Mickelson versus Tiger Woods using their publicly available statistics and plotted the results on a Point and Figure chart. We looked at Tiger as "the market" and Phil as the stock. It worked fine. It gave us some very interesting insight between the two players. We'll reserve more discussion on this for the professional golf Point and Figure charts we will do in the future. Hey, just kidding on the pro golf charts, but let your mind wander a little. What if? Like Bob Dunwoody says, "Sounds crazy, might work." Okay, back to the real RS charts. We use the SPXEWI as the divisor for a stock's Market RS, but you can choose to use another market index, such as the Nasdaq Composite or Value Line; just be consistent and always use the same index when you update your RS chart. Using the SPXEWI makes sense to us, though, since, as the name implies, it is an equal weighted index. This helps to eliminate the capitalization or price bias found in most other market indices. Previously, we used the Dow Jones Industrial Average as our benchmark to measure RS but changed over to the SPXEWI in February 2003 after S&P announced the creation of an equal weighted version of their S&P 500 Index. Besides having the appeal of being equally weighted, the SPXEWI is a much broader based index than the Dow Jones. One point we want to make before moving on concerns the scale used for an RS chart. It differs from the basic trend chart scale in that it is not a fixed box size scale, but rather a uniform percent scaling methodology that treats all stocks equally, regardless of price. This was another change that we incorporated in February 2003 after extensive, collaborative research by the home office in Richmond, Virginia, and our money management division in Pasadena, California. The efforts to make our RS tools even more robust and adaptable is an example of our commitment

to constantly striving to make DWA's technical analysis and research better for our clients.

2. *RS versus DWA Sector Index.* This is also known as peer relative strength. It measures how a stock is performing compared with its sector peers, as measured by the DWA sector indexes. For example, the peer RS reading would measure how Intel (INTC) is doing relative to other semiconductor stocks. This RS chart allows you to determine the strongest stocks within a particular sector, or what we like to call the "best in class." The peer RS calculation is equally simple, and is done by dividing the price of the stock by the appropriate DWA sector index chart, then multiplying by 100 to come up with a plottable number. The DWA sector indexes were created for each broad industry group we follow. These DWA sector indexes are equal weighted and include a nice mix of stocks with varying capitalization, unlike the exchange sector indexes, which tend to be more narrow and capitalization weighted. The uniform percent scaling method is used with this type of RS chart, too, as well as all other RS charts.

How to Calculate Relative Strength

Now that you understand the two basic RS charts we use for an individual stock, let's look at an actual example of each type of RS calculation.

Relative Strength of a Stock versus the Market

$$\text{RS Reading} = \frac{\text{Stock Price}}{\text{SPXEWI}} \times 100$$

This calculation uses closing prices and is done on a daily basis.
For example: XYZ Corp is at 81 and the SPXEWI is at 1252.

$$\frac{81}{1252} \times 100 = 6.47 \text{ RS Reading}$$

For example: XYZ Corp is now at 74 and the SPXEWI is at 931.

$$\frac{74}{931} \times 100 = 7.95 \text{ RS Reading}$$

In this case, the stock dropped in price and the SPXEWI also fell lower, but the RS reading for XYZ went up. This tells us that the stock is performing better than the SPXEWI, and it is possible that the only reason it has

fallen in price is that the overall market has dragged it down. These positive RS stocks will likely be the first ones to snap back once the overall market does. As a general rule, stocks with positive RS versus the market will typically outperform the market during a bullish market condition, and will be more likely to hold up and weather the storm in a bearish market condition over the longer term. When the market transitions from offense to defense, the high-RS stocks that have done so well versus others that have underperformed will likely experience profit taking while the underperformers will not. Take, for example, the market beginning in mid-2008. The positive RS stocks carried the ball for most of the year. Stocks like Apple Computer made a high in the first quarter at $196. Then, when profit taking in stocks that had high RS set in, Apple ended up at a low in 2008 of $80. That was a killer. The stock just bobbled around for the first quarter of 2009, but then in April it took off and has not stopped yet. Stocks like Coca-Cola simply did nothing in the last half of 2008, so there were no profits to be taken, making selling pressure minimal. As a general rule, high-RS stocks will underperform one quarter out of four. It is natural that when optimism turns to pessimism in the market, investors rush to nail down profits but hold those stocks that have done nothing. Then, once the profits are taken, they reassert their RS and are the first to begin the run-up once the offensive team comes back on the field. There are a lot of little nuances in investing that make up the market. In 2008, this exact phenomenon happened. As the banks deleveraged, they sold everything, and I mean everything. For the first time the modern portfolio theorists found out that everything could be correlated at one time. Those stocks that had profits were hammered along with every other stock. But when the recovery took place beginning in March 2009, the low-RS stocks that were on the verge of bankruptcy took center stage and were first to rally, but they were rallying from single digits. A rise from 2 to 3 is a 50 percent gain. Later in the year, the high-RS stocks reasserted themselves like a race car shifting into high gear, took off, and never looked back.

$$\text{Peer RS Reading} = \frac{\text{Stock Price}}{\text{DWA Sector Index}} \times 100$$

This calculation uses closing prices and is done on a daily basis.

For example: Lowe's Companies, Inc. (LOW) is at 26.50 and the DWA Building Index is at 236.

$$\frac{26.50}{236} \times 100 = 11.22 \text{ Peer RS Reading}$$

For example: LOW rises to 29.00 and the DWA Building Index is at 284.

$$\frac{29.00}{284} \times 100 = 10.21 \text{ Peer RS Reading}$$

In this case, LOW rose in price, the DWA Building Sector Index moved higher, but the peer RS reading for LOW went down. Now, let's substitute Home Depot (HD) for Lowe's in the previous example:

For example: HD is at 40.36 and the DWA Building Index is at 236.

$$\frac{40.36}{236} \times 100 = 17.10 \text{ Peer RS Reading}$$

For example: HD rises to 52.84 and the DWA Semiconductor Index is at 284.

$$\frac{52.84}{284} \times 100 = 18.60 \text{ Peer RS Reading}$$

In this case, HD rose in price, the DWA Building Sector Index moved higher, and the Peer RS reading for HD moved up.

This comparative example demonstrates how HD is outperforming its Building sector peers, while LOW is underperforming its peers. HD's peer RS reading moved up from 17.10 to 18.60, while LOW's Peer RS reading fell from 11.22 to 10.21. This particular type of RS reading allows you to identify the stocks that are the strongest of the group—the best in class—and these are the stocks that will likely perform the best within that sector. You have all heard of "market-neutral" hedge funds, right? Wouldn't it make sense in the preceding example to buy HD and simultaneously sell short LOW? Think about it.

How to Interpret the RS Chart

In evaluating an RS chart, buy signals are given when a column of X's exceeds a previous column of X's (also referred to as positive RS). Conversely, sell signals are given when a column of O's exceeds a previous column of O's (also referred to as negative RS). The pattern doesn't matter with the RS chart (e.g., whether it is a double top or triple top buy signal), just whether the most recent signal is a buy signal or a sell signal—a top being broken or a bottom being broken. In addition, unlike other RS methods, the RS "reading" or number itself doesn't matter; the results of these RS readings really don't come to life until plotted on a PnF basis. Once the chart is plotted, the RS picture unfolds and provides guidance. Questions are easily answered, such as "Is the RS chart in X's or O's?" "Is it on a buy signal or a sell signal?"

If you read my first edition book on Point and Figure charting, you will remember in the RS chapter I mentioned that I had found that the column was more important on the RS chart than the actual signal that developed, as it often indicated that a change in trend was occurring. Since then, we have done extensive work on the RS concept and made improvements to these charts, as discussed earlier.

Positive relative strength, or an RS buy signal, suggests the stock will outperform the market (or whatever you are comparing it to), while negative relative strength, or an RS sell signal, suggests the stock will underperform the market. But it is important to note that just because a stock has positive RS doesn't mean that it can't fall in price; it merely means that it should not fall as much as the market averages if that is what you are comparing it to. It's as the name suggests—it is a relative measurement, not an absolute one. It is also important to watch for RS reversals, or changes in columns, as this provides shorter-term guidance. While the RS signal indicates longer-term RS, the most recent column provides an indication of the shorter-term RS. If the most recent column on the RS chart is X's, it suggests the stock is outperforming in the near term; conversely, when the most recent column on the RS chart is O's, it demonstrates underperformance by the index in the near term. Also, if you continue to see an RS chart put in another X after another X, it suggests that the RS is only getting stronger or is rising. This is a good sign for a stock, showing that it persists in outperforming the market. Conversely, if a stock is in a column of O's and continues to put in more O's, it is telling you that this stock's RS is falling and therefore should be avoided. In sum, the best combination for the RS chart is to be on a buy signal and in a column of X's, while the worst is for it to be on an RS sell signal and in O's. Oh, one more thing. I find it very helpful to look at the last calculation on that RS chart so you can gauge if the RS is beginning to move in another direction. Say the last box in the RS chart is in X's at 20. A three-box reversal will happen at 18.50. If the last reading on the calculation was 20.4, then you know the RS chart is not losing any strength. Conversely, in this same example, if the RS chart was at 20 and the last calculation on that RS chart was 18.72, you are close to a reversal to O's and had better prepare for it.

The beauty of RS is that it can keep you invested in strong stocks for a long time, allowing you to participate in the gains—enabling you to catch the positive "outlier." Think about it for a second. If a stock continues to have positive RS for years on end, all while the market averages continue to record notable gains, what does that say for the particular stock? Well, the only way a stock can continue to have positive RS versus a market that is moving

higher is for it to move higher in price and at a faster pace than the market. In essence, RS allows you to let your profits run, with the (positive) RS chart providing a clear-cut reason to do so. This statement fits with the fact that a stock's (market) RS signal will typically last about two years on average; and generally speaking, it tells us the overall expected trend of the stock. Yet there are plenty of examples of how RS can stay positive or negative for years on end. For example, IBM had positive RS from November 1996 to October 2000; then, its RS chart remained on a sell signal from October 2000 to February 2009. Since August 2012 it is still trading on the buy signal it gave in February 2009 and the trend chart looks fantastic. I would buy IBM right now. More staggering is the fact that Dell Computers (DELL) was on an RS buy signal from November 1993 to April 1999—during this time the stock was up 100-fold! Alternatively, DELL's most recent RS sell signal came in September 2005 and the stock has lost over 60 percent of its value to August 2012. Things change. Danaher (DHR) has been on an RS buy signal for 20 years, since May 1993. The outperformance during the expansive time frame from May 1993 to the writing of the last edition of this book was incredible—with DHR up 1,545 percent compared to the SPXEWI, which posted a not-so-shabby return of 256 percent over that same period. Now fast-forward to this book in 2013 and guess what? Danaher has not changed from a buy signal on its RS chart since the last book. What a stock! In 2007, the stock hit a high of $44 and at the bottom of 2008 it hit a low of $24. During 2009, the RS chart did move into a short-term column of O's but never gave a sell signal. But just as RS works well to pinpoint outperformance, there are dramatic instances of how it warns of long-term underperformance. Take Eastman Kodak (EK). This stock was on an RS sell signal for 12½ years, from March 1992 to September 2004, and the numbers shouted underperformance, with EK losing 22 percent in a little over a decade while the market gained 242 percent. This year EK filed bankruptcy. RS never really let you back into the stock. It is a great example of taking your eye off the technology ball. Technology blindsided them, end of Kodak's story. Another example of this is WorldCom. On page 100 of the second edition of this book, I recommended avoiding or selling short WorldCom before any of the negative news came out. Who could have tipped me off to this? The RS chart did. I said the following: "Overall weak RS stocks that reverse back to O's are dangerous, and in most cases should be avoided, or potentially shorted. A case in point is WorldCom (WCOM)."

Another beneficial aspect of RS is that it allows you (or tells you) to get off a horse not running the race and to move to one that is. This is where

it's imperative to keep up with changes in RS. Each day, changes in RS will occur—some stocks will move from an RS buy signal to an RS sell signal and vice versa, and some will show changes in a column on their RS chart. The point is that you must constantly monitor the RS chart for changes. Our system at www.dorseywright.com will do this for you and alert you by e-mail or text message of any changes in stocks that warrant your attention. If you own a stock that has just given an RS sell signal, it is time to evaluate whether that stock should be sold. Also, by knowing when a stock has given a new RS buy signal or reversed up into a column of X's, it will alert you to a potential turnaround situation or viable investment opportunity. Some graphical explanations will make this concept easier to grasp.

Examples of Relative Strength Changes for Stocks versus the Market

It never is too hard to find classic examples of RS, merely because the concept is so dynamic and robust. But, I must say some of the more dramatic illustrations of RS at work come from the year 2000. We all remember this time period—some fondly, while others are still licking their wounds from losses incurred following the tech meltdown. Those that used technical analysis, and in particular RS, came through the 2000–2002 time period relatively unscathed. The evidence of a major top in technology and telecom stocks was right before your eyes, if you were willing to look. The same can be said for the meltdown in 2008. It is interesting how we went through 2008 not owning any stocks due to our Dynamic Asset Allocation strategy. It is all RS based. By the same token, sectors changed early on before anyone saw the subprime fiasco unfold. Building stocks' RS changed direction to negative in 2007, as did the financial stocks. Fundamental analysts rode the financial stocks right down the chute. Yogi Berra once said: "You can observe a lot just by watching." We watch a lot. Or should I say, our computers watch a lot.

I am currently in the process of putting money to work. I not only manage my own money but also the money of my extended family. I am always on the search for dividend yield stocks that have strong chart patterns. I am going to show you some of the stocks I have bought and some I am in the process of buying. Keep in mind I have a number of accounts I manage for myself including trading in general, commodity trading/investing, foreign stocks on foreign exchanges, municipal bonds, and quality stocks for

the long-term play. When I say "the long-term play," I mean I want to buy a good stock, fundamentally sound, great chart, and good dividend relative to what can be gotten in the market today. Here's how I think of these stocks. Say I bought a stock like Exxon Mobil (XOM) with a 2.15 percent yield. I would prefer it to be over 3 percent, but a pullback in the stock will raise the yield, so I will place on our system an alert to e-mail and text me when XOM reverses on its Point and Figure chart. I may also buy some now and begin to scale in. You see, there is no predicting. Stacking the odds in your favor is all you can do in an uncertain world. Here's another thing that goes outside the parameters of this book, and that's the geopolitical situation of the ever-changing world. There is no going back to the old days. There is only the future. What is happening in the future is that more and more emerging countries are gaining economic and political strength and operating outside the dictates of America, as they have operated for the last number of decades. I prefer to own stocks that have an international stake in many countries. For instance, Exxon earns 70 percent of its income from outside the United States. My guess is that this number will increase in the coming years. Now, let's say in January 2012, I am about to buy XOM. I look at the chart and I see the stock is near 100 percent overbought on its normal distribution. I turn to the RS chart versus the SPX (Standard & Poor's 500 Cap Weighted) and see that it has reversed up on the chart signaling that XOM was the right purchase over the SPX. This reversal happened one year ago, and neither XOM nor the SPX had much of a return over that year. The year 2011 was tough for all stocks. Next, I look at the RS chart of XOM versus the SPXEWI and find that it has not reversed up. Remember, I said we at DWA always compare the stock to the SPXEWI where every stock has an equal vote. Let's stop here for a second. The SPX, where the largest stocks in the index have the most influence on the price of the index as a whole, is like Congress. The biggest states in the United States have the most congressmen. California has far more congressmen than Rhode Island. However, each state has an equal number of senators, no matter how large the state is. So the SPX is like Congress and the SPXEWI is like the Senate. The RSP is an ETF of the SPXEWI. It is one of the most important products to come out in my 37-year career. It is interesting that all money managers are pitted against the SPX but never the RSP, when in actuality the RSP has been the most difficult to outperform for the past 12 years. The RSP and SPX trade totally differently, although they are the same 500 stocks. Never forget the returns I am about to show you. From December 2000 to August 2012, the

return for the SPX Cap Weighted, the index that all money managers are pitted against, is 5.35 percent. The same 500 stocks, only equal weighted (RSP), is up 64.09 percent, not including dividends for each. The RS chart pointed to owning the equal weighted RSP in December 2000. If all you are invested in is the S&P 500, which most investors do in one shape or another, wouldn't you like to have been alerted to switch from the SPX to the RSP? In my opinion, this is one of the all-time great stories on Wall Street. It goes to show that it doesn't have to be difficult to make money on Wall Street. You will be hard pressed to find a mutual fund that has done as well after fees and commissions. Remember, you only had to hold the RSP for 12 years to get this return (commissions and other transaction fees excluded). Holding XOM for this same period would have yielded a 103 percent gain, not including dividends or fees.

Okay, let's get back to the January 2012 chart for XOM. I'm sorry for that little detour, but it all fits together—you'll see. It's so interesting; it's like playing chess or pool at a very high level. Since XOM has not reversed up on the equal weighted S&P 500 RS chart yet but has on the SPX chart, I will buy part of my position now. I also see on the chart on the right-hand side, the bell curve suggests the stock is near 100 percent overbought. This suggests to me that I buy on a pullback. I can't be sure the pullback will happen from this level or a higher level. So I will buy half my position now. This ensures that I at least put my foot in the stirrup and I can begin to work in the rest of the stock. This is how you construct a position instead of going all in. The information our research service provides is exactly what is needed to think clearly about constructing and managing a position. Let's look at the chart of XOM (Figure 4.2).

Where's the Relative Strength Been or Not Been?

While the raw materials stocks did poorly last year (2011), they appear to have a fire lit under them now. A good proxy for the raw materials sector is the iShares S&P North American Natural Resources Sector Index Fund (IGE). Otherwise, the big-name U.S. stocks are the place where all the action is taking place. It's like the old Nifty Fifty are back in vogue. In 2012, it was very difficult to stay up with the basic SPX. When the SPX is the place to be, the top 40 capitalized stocks pull the index around. This is a time where you have a bull market in indexes,

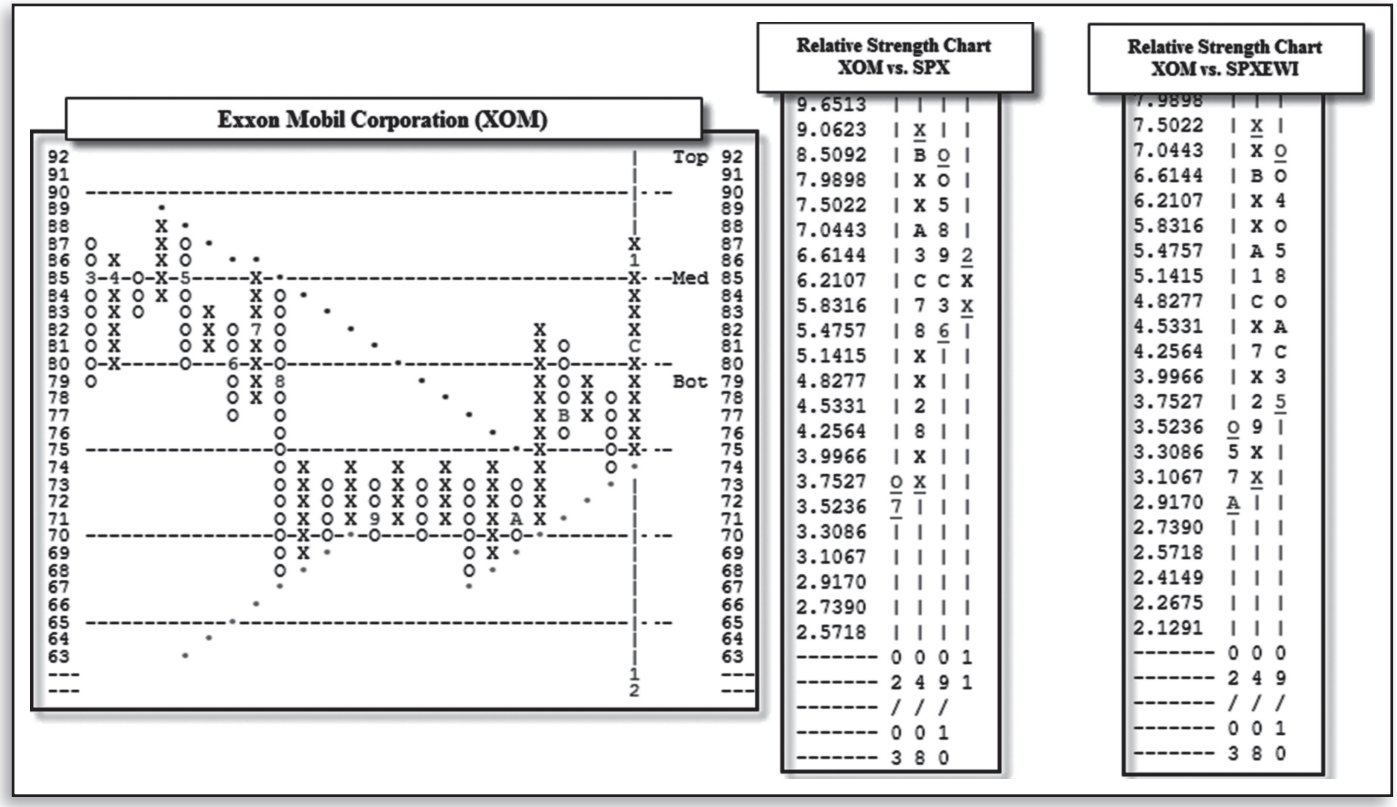


FIGURE 4.2 Exxon Mobil Relative Strength

not necessarily in stocks, and asset allocation generally underperforms during this period. This is clearly evidenced when you look at the returns between the SPX and the S&P 500 Equal Weighted in 2012. As of August 2012, the SPX was up 12.40 percent, while the RSP (Equal Weighted S&P 500) was up 11.24 percent. In the last edition of this book, companies like Coca-Cola, Ford Motor Company, and Wal-Mart had been taken out to the woodshed. Today, in the fourth edition of this book, Coke and Wal-Mart are stellar performers, but Ford is in trouble (see Figure 4.3). Over the past one-year period, Wal-Mart has been one of the best performers, moving from $50 to $74. Coca-Cola has moved from $31 to $40, but Ford Motor Company seems to be in trouble, having lost over 40 percent since January 2011. People aren't buying cars, but they aren't giving up their Cokes.

Spotting Positive Divergences

This leads us to a discussion on market divergence. In addition to the way RS was utilized in the preceding examples, it is also important to use RS to determine market divergence during times of weakness in the overall market. As discussed in later chapters, our market indicators will help dictate whether you should be playing offense or defense against the market. When defense is recommended, it becomes necessary to evaluate your portfolio positions all the more closely. This is a great time to get rid of your underperforming stocks. If those stocks haven't kept up while the market has headed higher, they are not likely to hold up well if the market moves lower. RS becomes a valuable tool to help determine which stocks get sold and which stocks are kept. Given that the market, on average, goes up two thirds of the time, and down one third of the time, going to 100 percent cash by selling all your positions is a huge bet. A more sensible approach is to weed out the poor RS performers and sell those stocks to raise the cash level in your portfolio. Keep the strong, positive RS stocks since they will be more resistant to decline, and will likely snap back once the market gets back on solid footing.

There is another aspect, or way to visualize market divergence and RS. During market corrections, it is important to observe whether a stock (or group of stocks in the same sector) is showing higher bottoms on its trend chart while the market averages are making lower bottoms. Often, there is a change in leadership after a market correction; in many cases, subtle signs

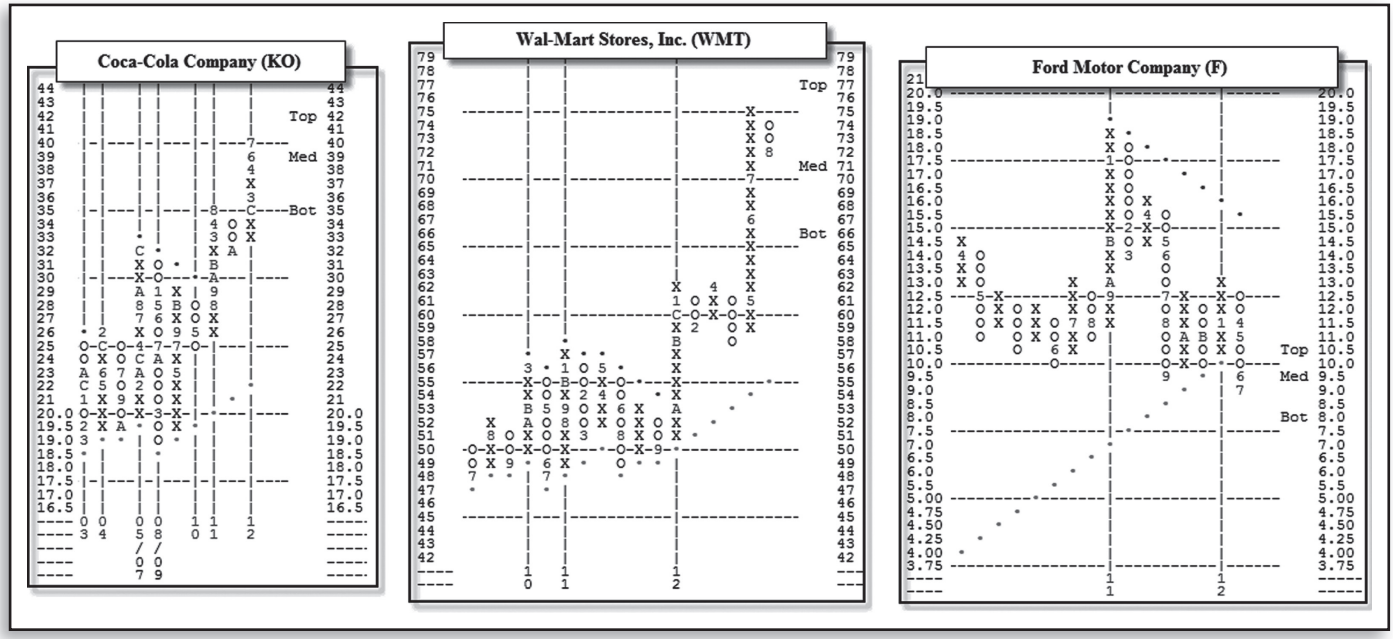


FIGURE 4.3 Relative Strength: Coca-Cola, Wal-Mart, and Ford Trend Charts

will occur even before the market as a whole has bottomed out. What is very helpful today is there are over 4,000 ETFs worldwide. In 2012, there are 1,500 ETFs just here in the United States. So let's think about this for a second. You see that copper stocks are on the move. You can, in a second, evaluate the whole natural resources sector by pulling up the iShares S&P North American Natural Resources Index (IGE). Then, if you like the sector, you can simply buy the IGE instead of getting stock specific. These are truly interesting times.

Sectors move in and out of season just like produce in the store as I mentioned before. It is your job to keep track of what's in season. In 2008 everything went out of season. It was like the grocery store was out of everything. All asset classes became correlated when modern portfolio theory taught for the previous 10 years that that could not happen. You have to accept "what is" in the markets. Never have any preconceived ideas. You might find one day that watermelons come into season in January. Don't eschew it—it is what is. Keep your eyes open. If you are dealing with a professional adviser, make sure they are experts in this methodology or you will be better off handling your account yourself.

Yogi Berra had some of the greatest all time quotes in my opinion, like "You can observe a lot just by watching." This one applies to keeping track of RS changes. Earlier this year, Moody's downgraded more than a dozen of the world's largest banks. These downgrades were in response to Moody's belief that the 15 downgraded were becoming weaker on a fundamental basis and would have a harder time servicing their debts. It also suggested that more fundamental weakness for the Banking sector could still be seen, especially the world's largest banks. Yet, from a technical standpoint, banks and the broad financial space remain favored, being driven by real estate, diversified financials, and the stronger, better positioned banks. Wells Fargo & Company (WFC), in particular, is a great example of a banking stock that is strong compared to some of the its weaker peers like Citigroup (C), UBS AG (UBS), or Barclays PLC (BCS). WFC recently moved to a new three-year high of $35, completing a spread quadruple top by exceeding its March 2012 high, as well as its February 2011 and April 2010 highs. In addition, WFC has managed to maintain positive RS versus its peers on both a short-term and long-term basis for some time now, having given a peer relative strength buy signal back in October 2011. WFC's strength relative to the market has also been improving. In fact, right now, Wells Fargo is one box away from an RS buy signal (Figure 4.4). This will be significant when it happens, as this market RS buy signal would suggest long-term strength over the market.

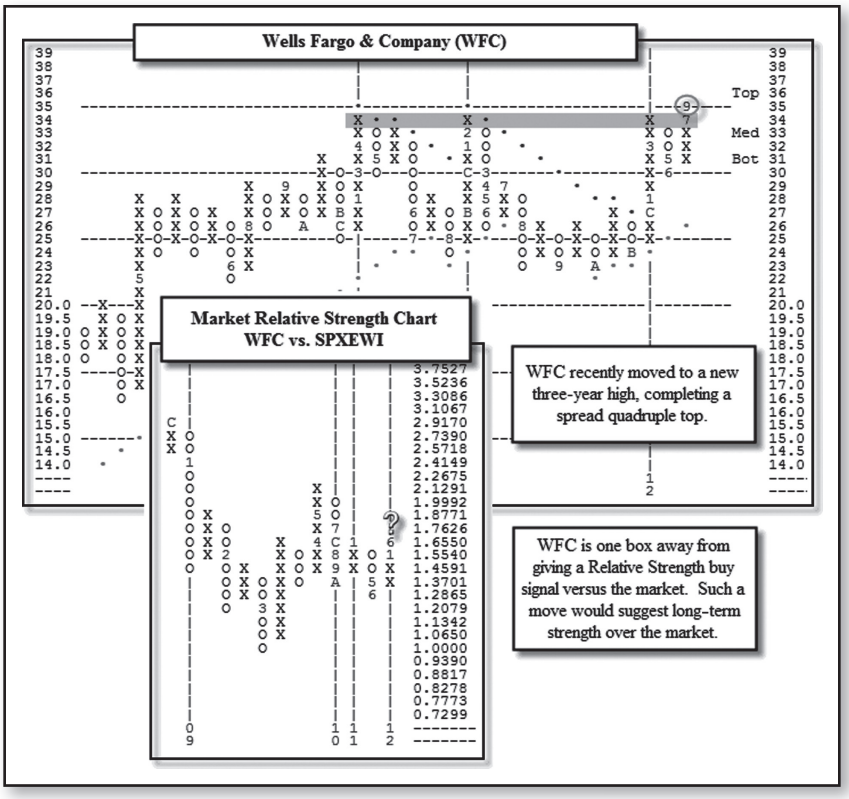


FIGURE 4.4 Wells Fargo Relative Strength Chart

Figure 4.5 presents a bank stock matrix. The matrix service is available on our web site and will be discussed in greater detail in Chapter 5, but I'll give it a brief introduction here. To me it's like a big arm-wrestling contest. Each stock is compared to each other stock on a relative strength chart. We then calculate the number of buy signals in this matrix and the number of columns of X's the stock won in the RS contest. In other words, the buy signals would be considered long term and the columns of X's would be considered short term. We then rank the stocks from best to worst based on the number of buy signals the stocks give in relation to one another. A look at the Banking sector matrix shows us that Wells Fargo is one of today's stronger bank stocks. WFC currently ranks fourth out of 28 bank stocks and the DWA Equal Weighted Bank Index on an RS basis offering further support to the strength and leadership we are currently seeing from WFC.

It is equally important to watch for negative divergences. Just as the trend chart of a stock can depict a positive divergence, it can also alert you to a

Rank	Ticker	Buys	Xs	Total Combo
1	BBVA	24	27	51
2	SAN	23	28	51
3	RF	23	17	40
4	WFC	23	14	37
5	USB	23	12	35
6	BBT	22	14	36
7	STI	21	22	43
8	FITB	20	19	39
9	TD	18	6	24
10	KEY	17	11	28
11	BAC	16	22	38
12	MTB	16	13	29
13	BOKF	16	9	25
14	PNC	16	7	23
15	BBD	13	21	34
16	NTRS	13	11	24
17	DWABANK	13	11	24
18	STT	13	1	14
19	CMA	12	8	20
20	RY	11	11	22
21	HBC	9	9	18
22	BK	9	6	15
23	MTU	9	2	11
24	JPM	8	12	20
25	C	6	22	28
26	BCS	4	25	29
27	NYB	4	5	9
28	DB	2	26	28
29	UBS	1	18	19

FIGURE 4.5 Relative Strength: Banking Stock Matrix

negative divergence. This is easily seen on the chart in the form of lower tops and bottoms, all while the market averages are showing higher tops and bottoms. When a stock shows negative divergence from the market, it is a warning sign that something is wrong, that the stock is losing RS. In most cases, it suggests you sell the stock or take some type of defensive action. This is evidenced in the chart of Ford Motor Company in Figure 4.6. The SPX has been demonstrating higher tops and higher bottoms while Ford Motor Company has been showing the exact opposite. Hope does not spring eternal here.

Changes in Relative Strength Column from Long Tails Up or Down

In a secondary fashion, it is important to pay attention to RS changes in columns. When a stock reverses back up into a column of X's on its RS chart, it is displaying positive near-term outperformance. An RS change in column to X's can also be helpful in identifying a turnaround situation. This can be especially true if the RS chart had previously been in a long column

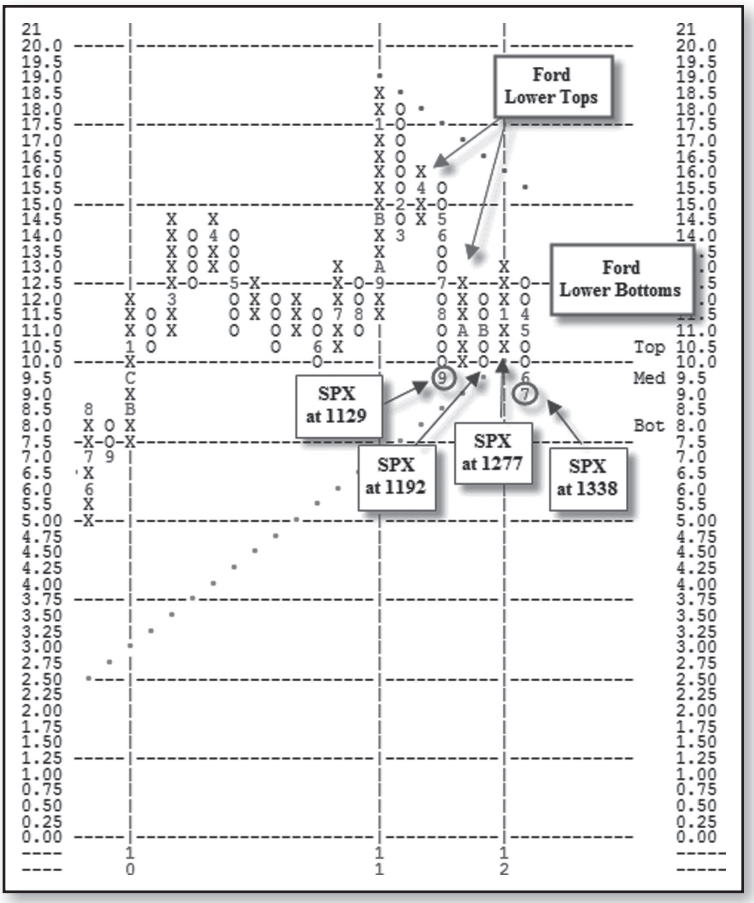


FIGURE 4.6 Ford Trend Chart

of O's down, either because the stock itself has been shunned or because the sector as a whole had been out of favor. Such instances can result in a long tail of O's on the RS chart. As a result, to technically get a buy signal on the RS chart, the column of X's back up would have to travel a long way to break the previous column of X's. For this to occur, the stock will have likely already experienced a huge move to the upside. Therefore, after a long tail down, it is acceptable to consider an RS reversal to X's as a buy signal of sorts, or at least a sign that the stock could be in the midst of a turnaround, and is worth you taking a closer look at the technical developments of that stock. I saw this situation many, many times years ago which is why in the first edition of *Point and Figure Charting* I discussed how the column was more important than the signal. Since then, we have changed the charts to

represent percentage changes and the signals come more frequently now. So what I do is look at the RS chart to see if a signal is close at hand. If so, I might wait for it to develop before I pile in. If the signal is not near, then the change in column is enough for me to go ahead and buy given all other pieces of the puzzle fall into place.

As an example, let's take a look at a stock we all love, Apple Computer. I like to use Apple because virtually everyone has an interest in that company. We have to take a time capsule back to 2006. Apple's RS chart had shown dramatic outperformance for a number of years as evidenced by the long column of X's up in the RS chart in Figure 4.7. Then, in February 2006, the RS chart reversed into O's. Because of the long tail of X's up on the RS chart, the column of O's would have had to travel a long way down before the RS chart gave a sell signal. Here, the reversal into O's was an early warning that the stock was about to take a breather or worse. Ultimately, the stock dropped from $75 to the low $50s before it began to rebound. This amounted to a loss of over 20 percent from the beginning of February 2006, when AAPL's RS chart reversed into O's, to July 2006, when the stock began to rebound. This kind of drop can easily scare many investors who say

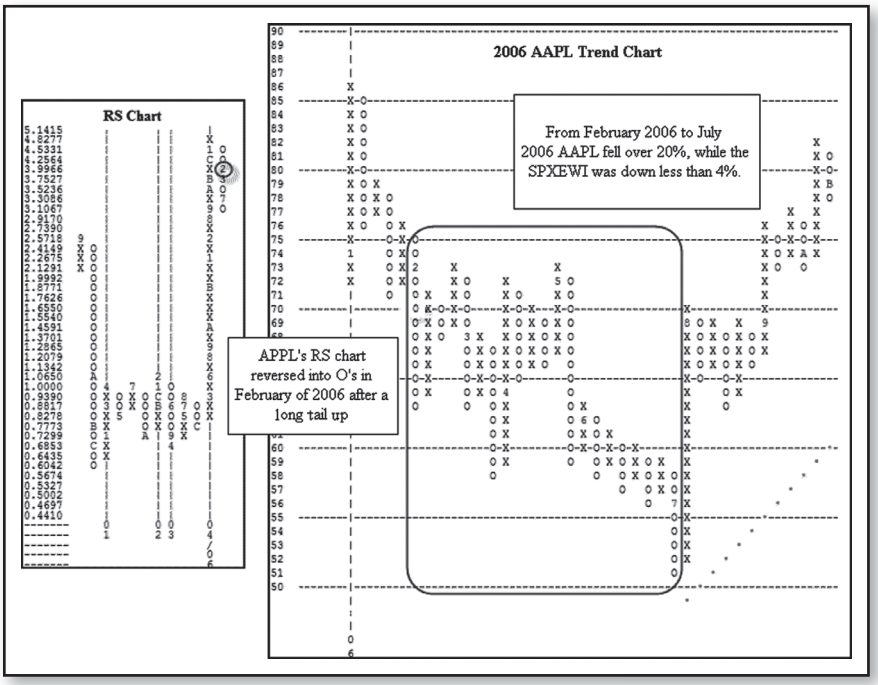


FIGURE 4.7 Apple Relative Strength Chart & Trend Chart

they are long-term holders, although this drop was nothing compared to the meltdown in 2008. That year alone Apple had a high around $200 and ultimately hit the $128 area. In March it rallied back up to a lower top and from there dropped to the mid $80s. This was a devastating year for investors. In 2009, those stocks with positive RS took off again and this time made new highs. Apple at its peak in August 2012 was at $624.

Coming Full Circle with Relative Strength

In finishing our discussion on RS of a stock versus the market, we want to leave you with one last example—one that we believe is a textbook example of using RS with overall trend analysis. Starbucks Corporation (SBUX) provides a great visual for how you can use both "absolute" and "relative" technical measurements together to position yourself to capture those large winning trades (Figure 4.8). SBUX illustrates the importance of monitoring both changes in trend and changes in relative strength, not only for entry into a position but also with respect to your exit. From April 1999 to February 2007 the relative strength chart of SBUX versus the market was trading on a buy signal, telling us that SBUX was experiencing long term outperformance versus the market. During that period, SBUX posted an impressive gain of 323.48 percent, dwarfing the 87.55 percent return of the SPXEWI during that same period. But things change, and you must watch for evidence of change. In February 2007, the period of outperformance came to an end when SBUX gave an RS sell signal versus the market. The breakdown of the SBUX's trend chart was quick to follow. In June SBUX gave a triple bottom sell signal when it fell below $28 and before the first quarter of 2008 was over, the stock had violated its bullish support line, changing its overall trend to negative. As illustrated by the first trend chart below, SBUX saw a drastic decrease in its price during the period in which its relative strength chart was on a sell signal. The stock lost 67.15 percent, underperforming the SPXEWI, which was down 53.34 percent during that period. Then, after over two years of negative RS, the tide turned again for the international coffee company. SBUX gave an RS buy signal in March of 2009 after its trend chart gave an initial buy signal off the bottom. Starbucks followed this positive signal and broke through the bearish resistance line, thereby changing its overall trend to positive and it was straight up from there. At this writing in August 2012, SBUX is

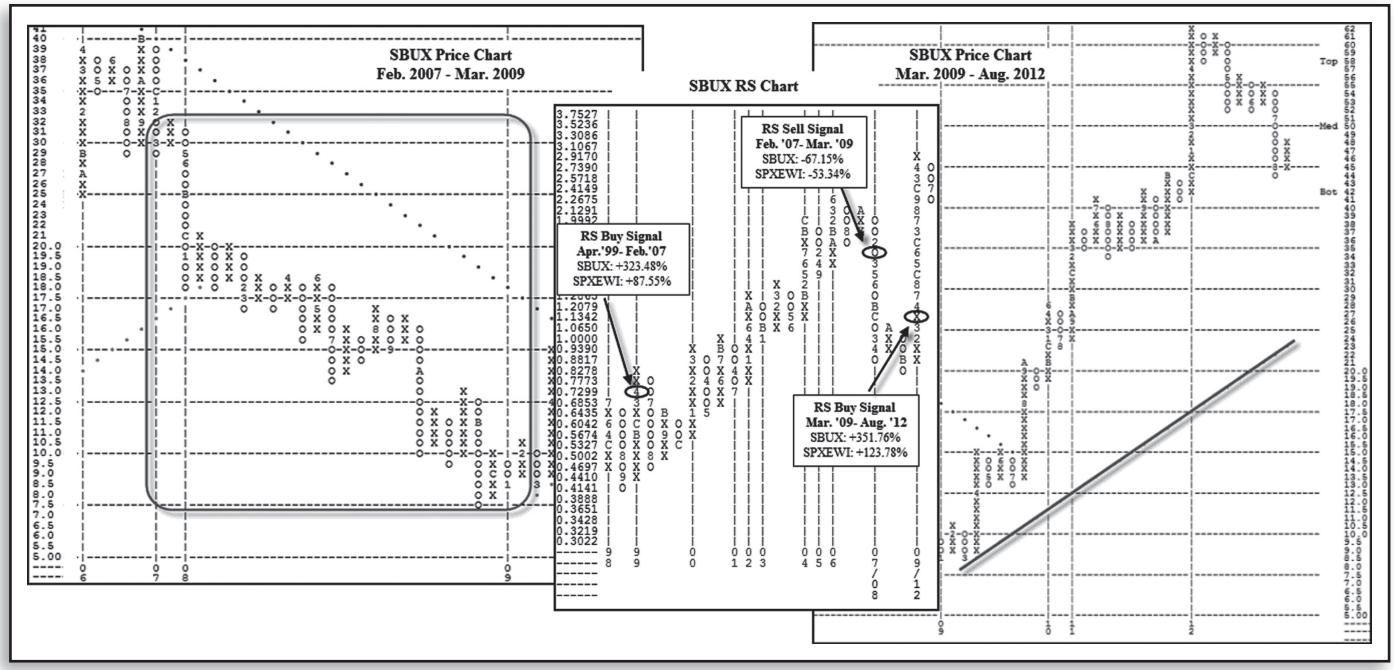


FIGURE 4.8 Starbucks Trend Chart and Relative Strength Chart

trading at $48, having gained over 351.76 percent since its RS chart turned positive compared to the SPXEWI, which is up 123.78 percent since March 2009. As with life, and the stock market, what goes around, comes around. Therefore, it is imperative to adapt to changes in such things as trend and relative strength.

Examples of Peer Relative Strength Changes for Stocks

The evaluation and interpretation of the peer RS chart is the same as the stock's RS chart versus the market. Similarly, we are interested in the most recent signal on the peer RS chart, and current column the chart is in, be it X's or O's. Here, as well, the best combination for a peer RS chart is to be on a buy signal and in a column of X's. Since peer RS measures how a stock is doing relative to its sector siblings, a positive peer RS (buy signal) reading implies the stock is outperforming an index of its related peers. The purpose of peer RS is to steer you to the stock(s) that will likely perform the best within any given sector.

A good illustration of the power of peer RS involves DSW, Inc. (DSW) and the Retail sector. As Figure 4.9 illustrates, DSW was on a peer RS sell signal versus the DWA Retail Index (DWARETA) from September 2007 to October 2009. The negative peer RS implied that DSW would underperform its sector peers during this time and that is exactly what we saw. DSW was down 28.06 percent over this two-year stretch while the DWARETA Index was up 17.29 percent. The index as a whole outperformed DSW by over 45 percent but remember that peer RS does not speak to the performance of the underlying group, only to the performance of the underlying stocks compared to the group. By October 2009, DSW's performance had turned around and the stock started to outperform its retail peers, as evidenced by the peer RS buy signal on October 15, 2009. After two years of underperformance, this change in signal now implied that DSW was ready to be one of the leaders in the group and the performance numbers confirm it. As of this writing (August 2012) DSW is up a whopping 222.58 percent, while the DWA Retail Index is up 66.67 percent. DSW is up well over three times that of the average Retail stock!

To take it a step further, let's look at the impact of not paying attention to Peer RS with respect to your stock selection. For this example we will once again use the Retailing sector. After getting crushed in 2008 the Retailing

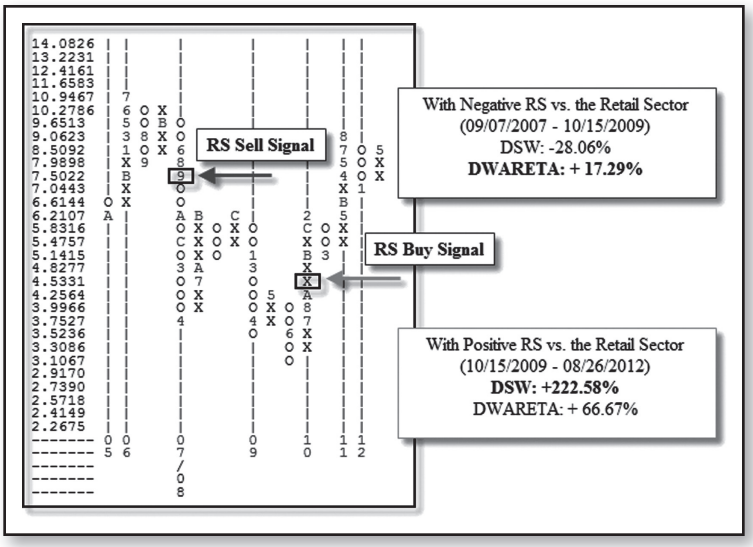


FIGURE 4.9 Peer Relative Strength: DSW versus the DWA Retail Index

sector began to rebound during the first quarter of 2009 and throughout that year, the sector showed strength above and beyond that of the broader market and other sectors. One stock that presented itself as a viable candidate for purchase was DSW. But some may have said, "It doesn't matter what stock I buy in Retailing." Well, it does matter, as Figure 4.10 concludes. Let's hypothetically say that on a fundamental basis you had narrowed your Retail stock selection down to two names—DSW and J. C. Penney Company, Inc. (JCP). From there you may have said, "flip a coin" to decide which one to buy. That would have been a very bad decision. Instead, a glance at the peer RS charts would have provided all the information you would have needed to make the final decision as to what stock to buy. In October 2009, DSW had given a peer RS buy signal while JCP remained on the peer RS sell signal it had given in July 2008 and in O's. This alone suggested that JCP was and would continue to underperform its fellow Retail sector members, and that DSW was likely to continue its outperformance. Through August 2012, these same peer RS signals remain in force with DSW up 222.6 percent since October 2009 compared to JCP's negative return of −32.3 percent during that time. During that same period of October 2009 to August 2012, the DWA Retail Index was up 66.7 percent and the S&P 500 Equal Weighted Index was up 37.7 percent. So you see, it did matter which Retail stock you selected. This is a simple example of

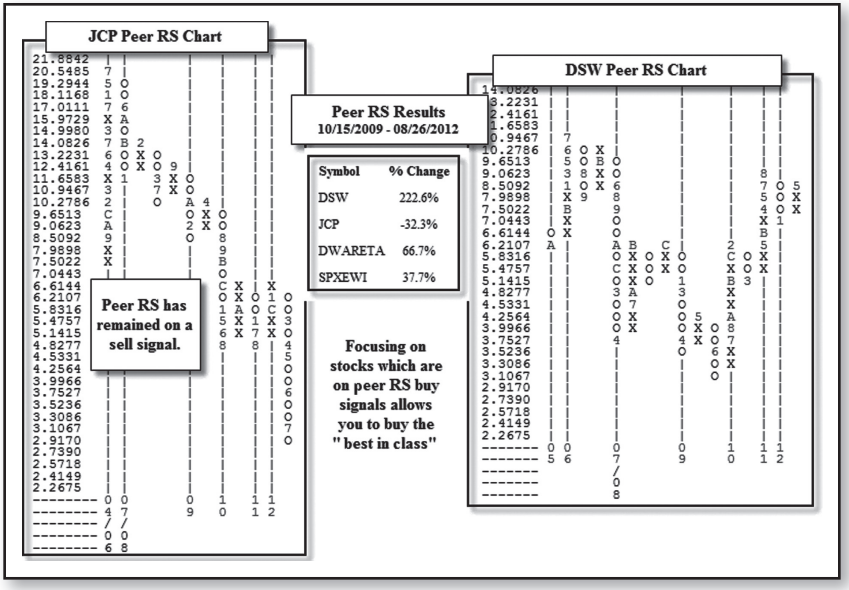


FIGURE 4.10 Peer Relative Strength: DSW versus J. C. Penney

how you can potentially choose the right sector to play, but not necessarily the right stock. Peer RS endeavors to guide you to the best in class, in this case to DSW instead of JCP. A good general rule, then, is to focus your buying on those stocks that have positive RS versus both the market and their peers. This will help immensely in narrowing the list of potential buy candidates down to a reasonable number. This is what we are trying to do, in general, in this book. We are taking the fire hose of information investors are bombarded with each day and rendering it down to the trickle of a garden hose. That's really the whole ballgame.

Peer RS becomes extremely beneficial when a sector rotates back into favor, as the example demonstrated. We all know that sectors rotate in and out of season just as vegetables and fruits do in the grocery store. Therefore, to achieve consistent returns over time, it is crucial to maneuver in and out of sectors as the indicators dictate. Can you imagine how well a clothing store would do all year if they didn't change their inventory to reflect the current or upcoming season? At DWA we have numerous sector evaluation tools at our disposal to help guide us to the right sector(s) at the right time; we will discuss these tools in more detail later.

The peer RS chart is quite valuable in this maneuvering process, specifically when it comes down to actually selecting the stock(s) you want to play

within that sector. By identifying the stocks within the sector that are outperforming their peers, you are able to find the strongest of the group—and they are the ones most likely to perform the best as the sector strengthens. The search/sort function on our web site is extremely effective in handling this task. We have a favorite search we conduct when trying to find the best stocks in a sector that has rotated back into favored. Let's assume the Real Estate sector has just moved back into favor, and therefore is a sector that we want to gain exposure to; the search criteria would go as follows:

- All stocks that are on an RS buy signal versus the market, but allow for the most recent column to be either X's or O's.
- All stocks whose Peer RS chart is on a buy signal and in a column of X's.
- All stocks that are members of the Real Estate sector that are in a positive trend, trading above their bullish support line.

The results of the query would give us a list of Real Estate stocks that have been outperforming the market over the longer term (denoted by the RS buy signal versus the market). Finally, only those stocks in a positive trend, showing absolute price appreciation over time would have made the cut, in addition to having met the strict RS requirements. This list of candidates could be narrowed down further by requiring the stocks to be fundamentally sound. With a couple of clicks of the mouse, this query would allow us to reduce the number of potential buy candidates down to a very reasonable number. A further technical review could then be administered to decide which stock(s) should be bought from the list produced by the query. The goal is to pinpoint those stocks within the sector with the best RS, and as you have learned this chapter, it is these stocks that will likely lead the sector up as the sector strengthens.

Had you administered such a search/sort back in August 2010, five months after the Real Estate sector had moved back into favor, Simon Property Group, Inc. (SPG) would have made your final cut as a buy candidate. However, Mack-Cali Realty Corporation (CLI) would not have made the cut. To this day, CLI remains on the peer RS sell signal it gave in November 2005, while SPG continues to trade on the peer RS buy signal given in August 2002. Since August 2010 SPG is up 77.6 percent, while CLI is down nearly 17 percent; and the DWA Real Estate Index (DWAREAL) is up 37.7 percent, while the SPXEWI is up 26.3 percent. Simon Property has been the leader, and Mack-Cali Realty has been the laggard, just as the RS implied.

Another application of peer RS involves sector divergence. If you have representation in a particular sector, there may be times you should swap

out one name for another because of a peer RS change. Using the previous example, let's say you owned Mack-Cali Realty (CLI) in the Real Estate sector, and the sector continues to be an area where you want exposure. CLI then gives a sell signal on its peer RS chart, and the technical picture in general has deteriorated. One strategy would be to swap out CLI for a stock that has positive peer RS in the Real Estate sector. This allows you to have sector representation in Real Estate, but realigns the token position to one with better peer RS, which by definition has a better likelihood of outperforming the discarded CLI.

As the Simon Property/Mack-Cali example (Figure 4.11) would suggest, emotional attachment to a stock because of its name or any other reason, can be detrimental to the overall portfolio's health, and ultimately can be a big drag on performance. This is why technical analysis, in particular RS, is so powerful and unbiased—it concisely quantifies outperformance or underperformance. When a security moves into a laggard, underperforming position, you need to unemotionally detach yourself from it; sell it to make room for the leaders, such as SPG in this example.

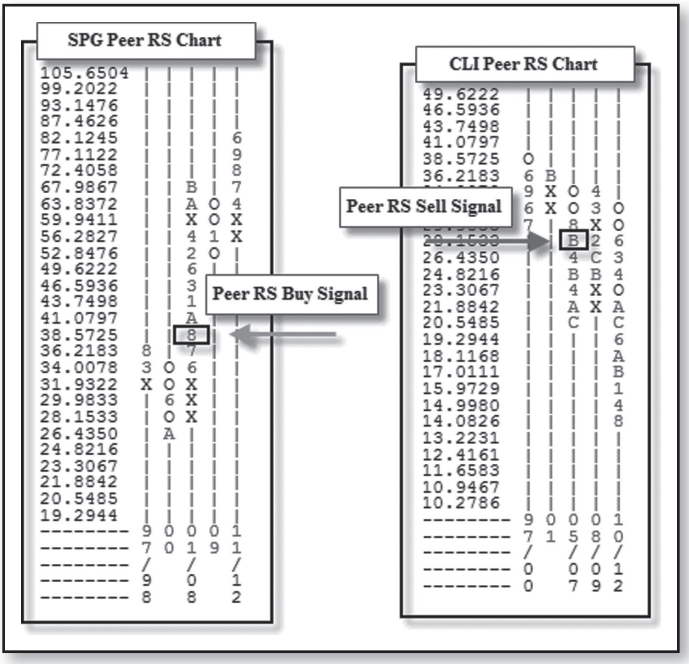


FIGURE 4.11 Peer Relative Strength: Simon Property and Mack-Cali Realty

Putting It All Together with Technical Attributes

Over the course of this chapter we have tried to impress on you the importance of RS. As presented so far, we use two basic RS calculations for stocks. To that end, you have learned the definition and how to calculate and interpret these RS charts. Of course, the significance of each RS measurement by itself is notable, as you have seen from the previous examples, but the real power lies in bringing this information together in a succinct manner. Therefore, to facilitate a more concise representation of a stock's technical aspects, which includes RS, we developed what we call our "positive technical attributes" reading. This, in essence, provides a summary of what you have learned so far, and provides a way to easily rank stocks on a technical basis.

DWA's positive technical attributes reading (for a specific stock) is comprised of five criteria, with a heavy emphasis on RS. They are as follows:

Positive Technical Attributes

1. A stock's RS signal versus the market (on buy signal)
2. A stock's RS column versus the market (in X's)
3. A stock's RS signal versus the peer group (on buy signal)
4. A stock's RS column versus the peer group (in X's)
5. Overall trend of a stock (is it trading above the bullish support line?)

There are five possible positive technical attributes a stock can have, as listed above. Strong stocks have at least three out of five of the criteria positive, and this is where your buying should be focused. Conversely, weak stocks, and typically ones to avoid, are those that have positive technical attribute readings of 0, 1, or 2 out of 5 (positive). In other words, strong stocks are those that are trending higher with superior RS, while weak stocks are typically those in a negative trend with poor RS. There are three charts to consult when determining what the technical attribute reading is for a stock—the trend chart of the stock, the RS chart of the stock versus the market (SPXEWI), and the RS chart of the stock versus its peers (DWA Sector Index). As the list lays out, four of the five possible technical attributes are RS based—two are longer term in nature, dealing with the RS signals, and two are shorter-term based, dealing with the RS columns. In sum, the positive technical attribute reading merely provides a quick, easy way to summarize the strength

of a stock versus the market and the sector, in both an absolute and relative manner.

We have back-tested the technical attribute readings and found that you can easily manage a portfolio of stocks using these attributes. When the attribute is above 3, hold the stock. When it drops to 2 or lower, it suggests the stock is not operating on all cylinders of the stock's engine. I have this problem with my boat. I have a boat with twin 150 horse Yamaha two-stroke motors. They are old and losing power. I am in a situation of either buying two new motors at a cost of about $20,000 or trading the boat for something newer. To sell the boat for maximum value I would have to sink another $20,000 in it, or the person who buys the boat will have to do the same. I am in a situation where the relative strength of my current motors has declined to 2 or below. The boat has to be sold. I guess it's time I buy my dream boat, a pleasure tug.

Although our DWA charting database provides the positive technical attribute reading for each stock for you, an example of how we arrive at the reading may be helpful. For this, let's take a look at Dr. Pepper Snapple Group (DPS) because it affords an excellent illustration of how the positive technical attribute reading can change, and how to arrive at the reading. As discussed earlier, we need to analyze three different charts to ascertain what the positive technical attribute reading is for DPS: the trend chart, the peer RS chart, and the market RS chart. As this series of charts displays (Figure 4.12), DPS experienced a relatively orderly march from being a technically weak stock to becoming a technically sound stock. Over the course of roughly eight months, Dr. Pepper upticked from a 1 for 5 status to a 5 for 5'er, which is the best reading a stock can have with respect to positive technical attributes. In December 2008, Dr. Pepper's lone positive technical attribute came from the fact that its market RS chart was on a buy signal, telling us that DPS was outperforming the market (SPXEWI) from a longer-term perspective. However, at that time, the market RS chart was still in O's, showing that DPS was underperforming the market in the near term. This changed when the DPS's market RS chart reversed into X's in February 2009. At that point, the market RS chart was telling us that DPS was experiencing both short- and long-term outperformance versus the SPXEWI and the stock's positive technical attribute reading rose to a 2 for 5. The next improvement came from the peer RS chart. DPS began outperforming its peers, as measured by the DWA Food & Beverage Index (DWAFOOD) in the short term, and as a result its peer RS chart reversed into a column of X's in late March 2009. This caused the positive technical attribute reading to uptick to a 3 for 5 reading. The

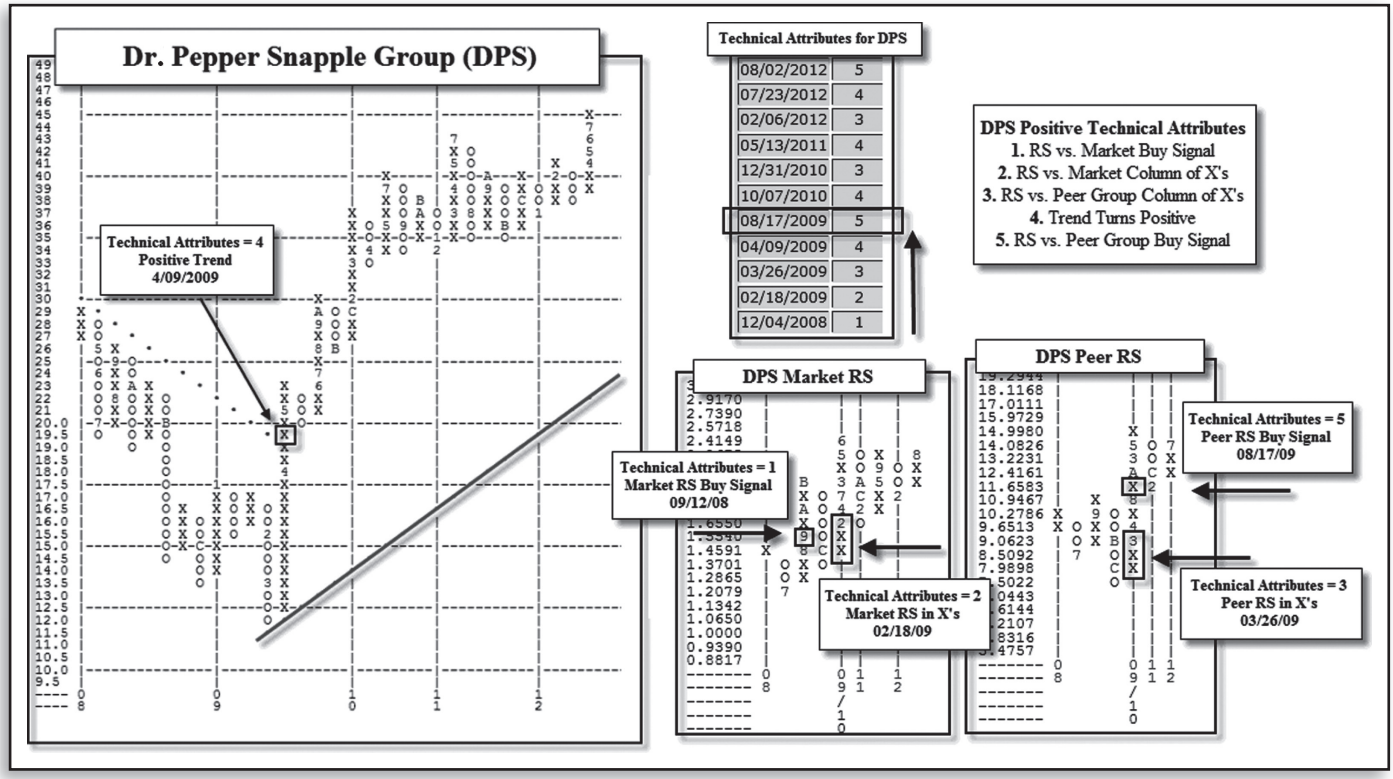


FIGURE 4.12 Technical Attributes: Dr. Pepper Snapple Group

beverage company's trend chart was the next thing to switch to positive, having broken through its bearish resistance line in early April 2009, moving the positive technical attribute reading to a 4 for 5. Finally, on August 17, 2009, DPS's peer RS chart gave a buy signal, implying that the stock was outperforming its sector siblings from both a short- and long-term perspective. The peer RS buy signal pushed the positive technical attributes up to a perfect 5 for 5 reading.

When we initially started this discussion on technical attributes, we said that you should relegate your buying to those stocks whose technical attribute reading is 3, 4, or 5 for 5. But we do want to add a general rule of thumb to that statement—focus your buying on those stocks that are a 3, 4, or 5 for 5'ers *and* are in an overall positive trend. The trend component assures that you are seeing, over time, absolute price appreciation, too. So, in the case of DPS, strictly speaking, even though the stock had 3 of 5 positive technical attributes in March 2009, you would not have considered DPS for purchase until April 9, 2009, when the stock broke through its bearish resistance line, thereby changing its overall trend to positive. Even still, the returns for DPS from April 9, 2009, to present are dramatic, showing how robust the technical attribute ranking system can be. In sum, DPS has stayed in an overall uptrend, with either a 4 or 5 (for 5) technical attribute reading from April 2009 to August 2012. During this time, the stock has posted an impressive return of 131.4 percent while the average Food and Beverage stock gained 65.3 percent and the market, as measured by the SPXEWI, posted a gain of 85 percent.

Just as the example of Dr. Pepper illustrates how important it is to focus your buying on those stocks in a positive trend with a high positive technical attribute reading, it is equally important to avoid (or sell short) those stocks trending negatively with a low positive technical attribute reading (2 or lower). A case in point is Myriad Genetics, Inc. (MYGN). From the beginning of 2005 through the first quarter of 2009 MYGN's positive technical attribute reading supported owning the Biomedics/Genetics Company and the stock performed very well, posting an impressive return of over 300 percent. However, in the second quarter of 2009 MYGN's technical picture began to deteriorate and the stock's positive technical attribute reading slipped below the acceptable 3 level.

Once again, this is where the positive technical attributes could have been of great help, steering you away from MYGN when the indicators suggested it would be an underperformer going forward. In Figure 4.13, the technical attributes are listed chronologically for MYGN. Notice how

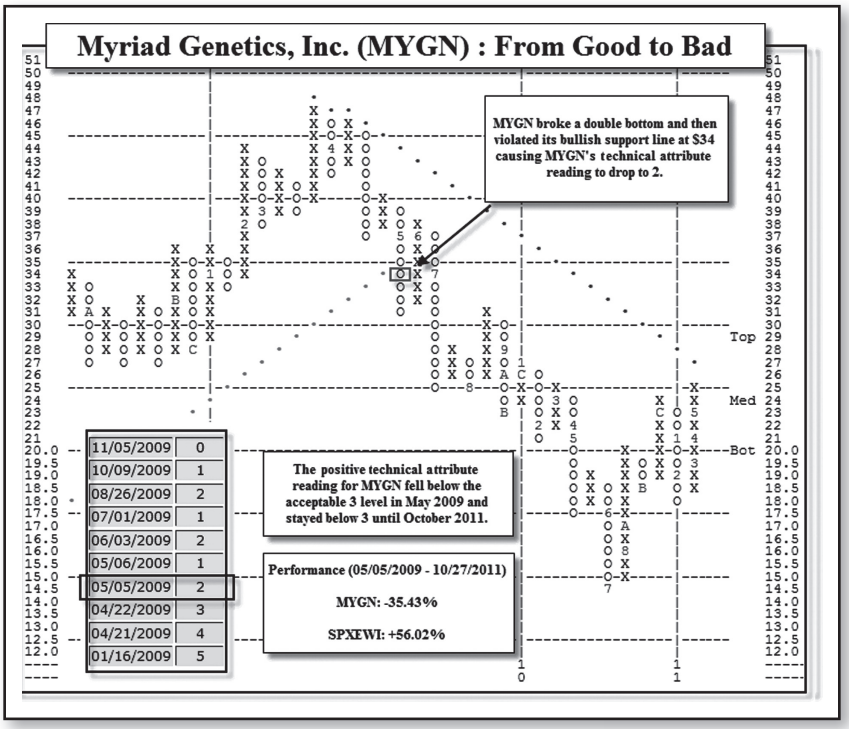


FIGURE 4.13 Technical Attributes: Myriad Genetics

MYGN's technical attribute reading began to slip in late April 2009. Then, on May 5, 2009, MYGN violated its bullish support line when it moved down to $34, thereby changing its overall trend from positive to negative and moving its positive technical attribute reading below the acceptable 3 level. In other words, starting in April 2009, MYGN was faltering on an RS basis and was starting to trend negatively, and therefore was a stock to exit or hedge in some way. For whatever reason, supply had taken control of this stock. As the lack of demand for MYGN's stock persisted, the technical attribute reading stayed between 0 and 2 for 5. It was not until late October 2011 that MYGN's positive technical attribute reading made its way back to the acceptable 3 level, meaning that from April 2009 to late October 2011 MYGN was an unacceptable investment on a technical basis. Over that period MYGN was down 35.4 percent, while the SPXEWI was up 56 percent and the average Biomedics/Genetic stock, as measured by the DWA Biomedics/Genetics Index (DWABIOM), was up 78 percent. On October 27, 2011, MYGN's positive technical attribute reading moved back

up to the acceptable 3 level and has since achieved a perfect 5 for 5 status. From late October 2011 to present the stock is up over 15 percent while the SPXEWI is up just 6.6 percent. Again, the positive technical attribute reading is a great way to quickly summarize the stock's strength from both an absolute and relative perspective. Focus your buying on those stocks in a positive trend with a high positive technical attribute reading (3, 4, or 5 for 5), and avoid (or sell short) those stocks trending negatively with a low positive technical attribute reading (2 or lower).

From an implementation perspective, technical attributes are not only helpful in deciding which stocks to purchase, but they are also useful in evaluating existing portfolios, especially portfolios being transferred over to you. As an example, let's take a look at a technical attribute study we do in the office using the Dow Jones Industrial Average. We update this frequently in our *Daily Equity and Market Report,* as it allows us to show our readers the benefits of applying technical attributes to their business. Most of you have likely seen this study or something similar. We take the 30 components of the Dow and split them into two categories: "weak attribute stocks" (2 or lower) and "strong attribute stocks" (3, 4, or 5 for 5). The objective is twofold: (1) to see how each component has done versus the market while in its respective attribute-based category; and (2) to show that by using the technical attribute system, we first and foremost capture the important longer-term trends.

The results of this study (updated in May 2012) are laid out in Figures 4.14a and 4.14b and yield several relevant pieces of information. For instance, not *all* weak-attribute stocks underperform, and not *all* high-attribute stocks outperform. Both Chevron (CVX) and Exxon Mobil (XOM) serve as examples of this, as both have been high-attribute stocks for the better part of the past year, but have lagged the S&P 500 Equal Weight Index (SPXEWI) by 7.85 percent and 2.26 percent, respectively. The Coca-Cola Company (KO), by contrast, has been a low-attribute stock for nearly four years and has performed almost 30 percent better than the market over that time. All of this to say that the attribute system is not a guaranteed failsafe solution to sidestepping such outcomes; however, the averages shown in Figures 4.14a and 4.14b speak to the real value added by this technical screening process. The study shows us that there are currently 17 stocks within the Dow that possess strong technical attributes and the average length of time the technical attribute rating has been "strong" (3 or better) is 501 days. The average outperformance for those 17 names versus the SPXEWI is roughly +15 percent.

Strong Attribute Dow Jones Industrial Stocks

Symbol	Company Name	Start Date	End Date	Number of Days	Stock Gain / (Loss)	Index Gain / (Loss)	Performance +/- SPXEWI
IBM	International Business Machines Corp.	7/25/2007	5/11/2012	1752	70.54%	-0.85%	71.39%
AXP	American Express Company	7/16/2009	5/11/2012	1030	110.89%	58.16%	52.73%
DIS	The Walt Disney Company	8/24/2009	5/11/2012	991	70.00%	40.50%	29.50%
MCD	McDonald's Corporation	11/6/2009	5/11/2012	917	48.90%	33.84%	15.06%
CAT	Caterpillar, Inc.	6/16/2010	5/11/2012	695	48.31%	20.47%	27.84%
DD	E.I. du Pont de Nemours and Company	7/27/2010	5/11/2012	654	27.71%	21.28%	6.43%
VZ	Verizon Communications Inc.	8/4/2011	5/11/2012	281	17.87%	11.16%	6.71%
KFT	Kraft Foods Inc.	8/5/2011	5/11/2012	280	11.96%	11.57%	0.39%
T	AT&T Inc.	8/5/2011	5/11/2012	280	16.11%	11.57%	4.54%
MSFT	Microsoft Corporation	8/8/2011	5/11/2012	277	27.29%	20.57%	6.72%
INTC	Intel Corporation	9/20/2011	5/11/2012	234	24.46%	11.56%	12.90%
HD	Home Depot, Inc.	9/21/2011	5/11/2012	233	48.85%	15.52%	33.33%
XOM	Exxon Mobil Corporation	9/28/2011	5/11/2012	226	15.30%	17.56%	-2.26%
CVX	Chevron Corporation	9/29/2011	5/11/2012	225	8.79%	16.64%	-7.85%
BA	The Boeing Company	10/12/2011	5/11/2012	212	14.37%	11.71%	2.66%
JPM	J.P. Morgan Chase & Co.	1/3/2012	5/11/2012	129	5.66%	5.75%	-0.09%
UTX	United Technologies Corporation	2/1/2012	5/11/2012	100	-3.79%	2.21%	-6.00%
		AVERAGES		501			14.94%

**Data as of 5/11/12*

FIGURE 4.14a Technical Attributes: Strong-Attribute Dow Jones Industrial Stocks

Weak Attribute Dow Jones Industrial Stocks

Symbol	Company Name	Start Date	End Date	Number of Days	Stock Gain / (Loss)	Index Gain / (Loss)	Performance +/- SPXEWI
KO	The Coca-Cola Company	6/27/2008	5/11/2012	1414	49.44%	20.37%	29.07%
MMM	3M Company	12/8/2008	5/11/2012	1250	51.15%	82.78%	-31.63%
JNJ	Johnson & Johnson	1/8/2009	5/11/2012	1219	9.01%	73.74%	-64.73%
PFE	Pfizer Inc.	2/6/2009	5/11/2012	1190	52.63%	85.08%	-32.45%
WMT	Wal-Mart Stores, Inc.	4/9/2009	5/11/2012	1128	17.29%	79.73%	-62.44%
TRV	The Travelers Companies, Inc.	1/8/2010	5/11/2012	854	33.07%	21.99%	11.08%
AA	Alcoa Inc.	1/28/2010	5/11/2012	834	-29.88%	28.86%	-58.74%
MRK	Merck & Co., Inc.	4/21/2010	5/11/2012	751	9.47%	12.42%	-2.95%
GE	General Electric Company	11/2/2010	5/11/2012	556	19.26%	12.48%	6.78%
HPQ	Hewlett-Packard Company	4/18/2011	5/11/2012	389	-41.76%	-0.25%	-41.51%
PG	The Procter & Gamble Company	2/3/2012	5/11/2012	98	1.45%	-1.49%	2.94%
BAC	Bank of America	4/30/2012	5/11/2012	11	-6.91%	-3.44%	-3.47%
CSCO	Cisco Systems, Inc.	5/11/2012	5/11/2012	0	N/A	N/A	N/A
		AVERAGES		808			-20.67%

**Data as of 5/11/12*

FIGURE 4.14b Technical Attributes: Weak-Attribute Dow Jones Industrial Stocks

However, the remaining 13 stocks in the Dow are categorized as "weak"-attribute names (2 or lower), and these stocks have been technically weak for an average of 808 days. In other words, once a stock falls below the threshold of 3 positive attributes, this condition of sluggishness can persist for an extended period of time. The average underperformance of these 13 names is currently –20.67 percent, illustrating the importance of keeping an eye on the technical attribute pictures for stocks that you rely on within your business. This screening process

can be a crucial aspect of your stock management strategy, and for the professional it can be an important part of your "story" with clients and prospects.

Another part of the "story" is also that while investing based on technical attributes alone will miss a number of modest periods of outperformance or underperformance, it will tend not to miss the important trends in the market. Within the Dow, the important trends have been International Business Machines Corporation (IBM), McDonald's Corporation (MCD), American Express Company (AXP), and Caterpillar, Inc. (CAT) over the past few years. Those trends were identified nicely. Many of you may not think of Johnson & Johnson (JNJ) as an "important trend" in the market over the past few years, as it has moved less than 9 percent in almost three years. However, that has meant a margin of underperformance of more than 64 percent when compared to the average S&P 500 component, and thus the JNJ trend was important to avoid. As a final illustration, Figure 4.15 takes the tables above and illustrates the relative performance of each Dow component since it achieved its current attribute rating ("high" or "low"). The strong attribute stocks have not all outperformed, but you can see the "outliers" have been captured in both directions, which is to say that important trends have been accounted for. Whether you are an individual or a professional investor, screening with technical attributes adds an important level of analysis to your process that is unafraid to say "sell" when a security indicates that it has likely gone into hibernation.

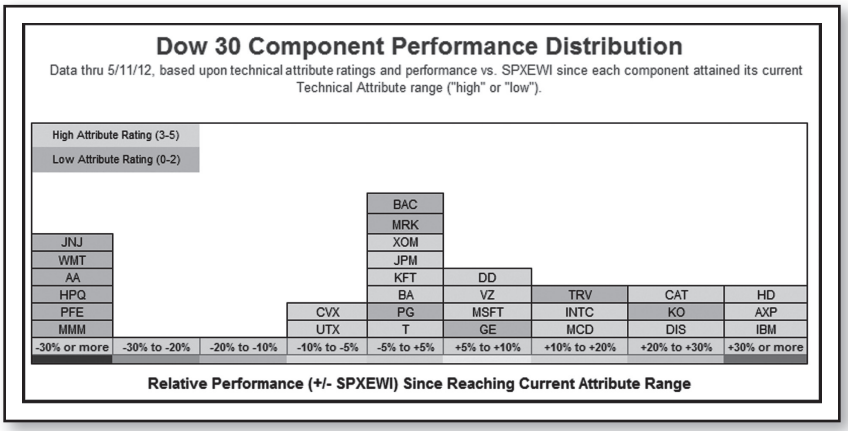


FIGURE 4.15 Technical Attributes: Dow 30 Performance Distribution

Summary

For a final illustration of the power of RS, we needn't look any further than James O'Shaughnessy's book, referenced at the beginning of this chapter. The fourth edition of *What Works on Wall Street* was released late last year and has the benefit of data that now goes back to 1926, whereas the previous editions went back only to 1963. O'Shaughnessy details the results of relative strength from 1926 to 2009:

> A $10,000 investment on December 31, 1926, in the decile of stocks from All Stocks with the best six-month price appreciation (All Stocks) is worth $572,831,563 at the end of 2009, *a compound return of 14.11 percent a year.* This return dwarfed an investment in the All Stock universe, which turned $10,000 into $38,542,780 over the same period, *an average annual compound return of 10.46 percent.*

It is also important to point out that O'Shaughnessy found that this RS portfolio outperformed the benchmark in 68 percent of single-year returns, 79 percent of rolling 3-year returns, 87 percent of rolling 5-year returns, 95 percent of rolling 7-year returns, and 98 percent of rolling 10-year returns. Additionally, keep in mind that this is just a generic RS strategy based on a six-month return factor with annual rebalances. His book also showed that using a 12-month relative strength factor also outperformed the benchmark with a compound return of 12.34 percent. In case you were wondering, a strategy based on buying stocks with the worst six-month returns and then holding for a year had an annualized return of 4.15 percent! As stated in the book, "If you're looking for a great way to underperform the market, look no further [than buying relative strength laggards]." Figure 4.16 illustrates what O'Shaughnessy had to say about the symmetry of relative strength deciles:

> The decile returns for All Stocks by six-month price appreciation reveal a perfect staircase, with the performance of decile 1—containing the best six-month price performing stocks—at the top and turns of the other deciles descending in step to the tenth decile, which contains the worst six month performers. The top six deciles all beat All Stocks, with the bottom four all underperforming the universe.

At DWA, we believe RS to be one of the most robust and adaptable tools for analyzing a particular stock. As you have learned in this chapter, RS is a very simple concept and is easily calculated. Clearly, though, this does not

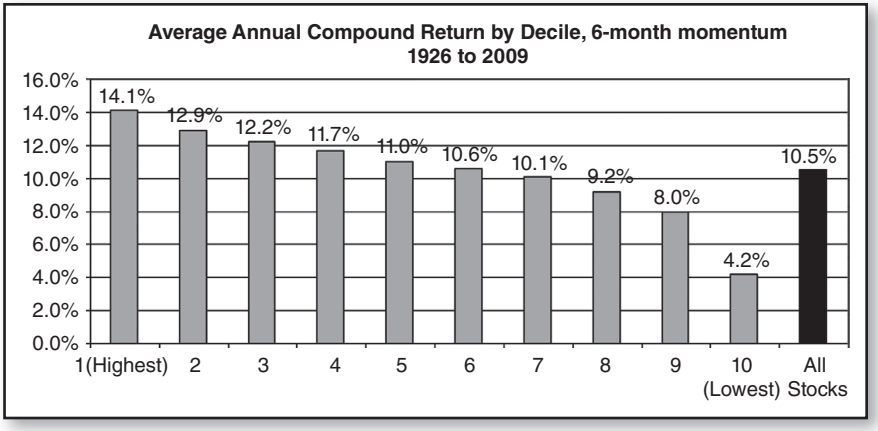


FIGURE 4.16 Average Annual Compound Return by Decile—Six-Month Momentum

diminish its effectiveness. Instead, by definition, RS on a Point and Figure basis, succinctly quantifies outperformance and underperformance. Stocks that exhibit positive RS are typically able to navigate the uncertain waters of the stock market much more easily than a stock with negative RS. By staying abreast of changes in RS, you are guided to new opportunities, while being steered away from danger. This enables you to capture the large winners or positive outliers. Remember, size does matter when it comes to your hard-earned money. Of course, not every trade is going to result in outsized gains; in fact, the bulk of trades (such as 80 percent) will produce small gains or small losses as a normal distribution suggests, but the key is to avoid the large losing trades. RS, and more encompassing—positive pechnical attributes provide a means for doing just that. Bringing an absolute measurement (trend), together with RS in a concise ranking or reading, as the positive technical attributes provides, the stock selection process is streamlined, yet without compromise to performance. As said, long positions should be focused on those names that are in a positive trend that carry a 3, 4 or 5 for 5 positive technical attribute reading, while those with a reading of less than 3 should be avoided.

Relative strength has no bias; it tells you unemotionally what is really happening. By making RS a key component to your stock evaluation, you will increase your odds of success, and that's the best you can hope for. It's as simple as that.

We manage the underlying indexes for four ETFs that trade on the New York Stock Exchange: PowerShares DWA Technical Leaders Portfolio (PDP),

PowerShares DWA Developed Markets Technical Leaders Portfolio (PIZ), PowerShares DWA Emerging Markets Portfolio (PIE), and PowerShares DWA SmallCapTechnical Leaders Portfolio (DWAS). We use RS exclusively in constructing and managing the portfolios. These ETFs are systematically rebalanced once a quarter in order to provide exposure to the top RS stocks in each of their respective categories, and are a great way to implement the concepts discussed in this chapter in a single CUSIP (Committee on Uniform Securities Identification Procedures) number.

CHAPTER 5

Advanced Relative Strength Concepts

In the previous chapter, we introduced the concept of relative strength (RS)—providing its definition and a basic interpretation of an RS chart as it pertains to a particular stock. The overriding theme was to demonstrate to you the robustness and adaptability of RS and how this simplistic tool enables you to capture the large winning trades while helping you to avoid the big losers. As you have learned, RS places you in the venues where outperformance exists, while steering you away from areas of underperformance. In this chapter, we will show you how RS can be used in many different applications, not just as it pertains to individual stocks, and that these other applications provide great insights into where best to allocate your investment dollars.

The beauty of RS lies in its lack of complexity—it is a simple calculation of division, comparing one security or index to another. Because of this simple equation, the concept of RS can be applied across the entire spectrum of financial products. In essence, anything that has a price associated with it can be used in an RS calculation. Although this sounds quite basic, it doesn't diminish its effectiveness in determining outperformance. In sum, RS can help to answer broad asset class allocation questions related to capitalization, style, fixed income, sector rotation, and even international exposure. Equally, RS permits you to pinpoint whether Pepsi (PEP) is a better choice over Coca-Cola (KO), taste buds aside; or whether crude oil is outperforming copper. The point is that the power and transferability of RS is endless, and only limited by your imagination.

In the following discussions on the different RS applications, a common thread exists. The calculation, as alluded to earlier, is the same no matter what you are comparing—you just divide one security by the other and multiply by 100. In addition, the plotting of the resulting RS reading is done using the same Point and Figure charting principles that were discussed previously, and with a uniform percent scaling method. The end result is the same—you focus your buying on those securities, sectors, indexes, or funds exemplifying the strongest RS, and sell or avoid those vehicles that display the weakest RS.

Sector Relative Strength

We first turn our attention to sector RS because of its importance in the investment process. As you will learn throughout this text, it is our belief that sector rotation is a very important key to your overall success in the markets. An oft-referenced study by Benjamin F. King (while at the University of Chicago) summarizes our reason for this posture. King's study found that approximately 80 percent of the risk in any given stock is attributable to the market and sector risk, while only 20 percent is due to the actual stock itself, and the majority of the 80 percent risk is due to sector influences. Not surprisingly, this is where sector RS comes into the mix. It is a given, based on studies such as the one referred to earlier, that determining which sectors are in "season," or are in demand, is imperative. So what better way to establish this than with RS? Recall its definition: a way to quantify outperformance and underperformance. It stands to reason, then, that one of the very best instruments you can have at your disposal to help navigate the equity market is sector RS. In essence, it is a tool that very easily helps you to analyze the greatest contributor to price fluctuation in a stock—sector risk.

The sector RS reading measures how a particular sector is performing compared with the market in general. For example, sector RS would measure how the Retail sector is performing versus the market. As suggested earlier, this allows you to ascertain which sectors are outperforming the market, while seeing which ones are "out of season," or underperforming the market.

Sector Relative Strength Calculation

The sector RS calculation is the same as those previously discussed. Daily, using the closing prices, each DWA Sector Index is divided by the S&P 500 Equal-Weighted Index (SPXEWI), and then multiplied by 100. The resulting

readings are then plotted on each sector's respective RS chart. Recall that our DWA sector indexes were created for each broad industry group we follow. These DWA sector indexes, of which there are 40, are equal weighted and include a nice mix of stocks with varying capitalization, unlike the exchange sector indexes, which tend to be more narrow and capitalization weighted.

Relative Strength of a DWA Sector Index versus the Market

$$\text{Sector RS Reading} = \frac{\text{DWA Sector Index}}{\text{S\&P 500 Equal Weighted Index}} \times 100$$

This calculation uses closing prices and is done on a daily basis. For example, we will calculate the sector RS reading for two indexes, the DWA Retail Index and the DWA Drug Index:

DWA Retail Index is at 712 and the SPXEWI is at 2071:

$$\frac{712}{2071} \times 100 = 34.38 \text{ RS Reading}$$

DWA Drug Index is at 742 and the SPXEWI is at 2071:

$$\frac{742}{2071} \times 100 = 35.83 \text{ RS Reading}$$

DWA Retail Index has now risen to 757 and the SPXEWI is now at 2110:

$$\frac{757}{2110} \times 100 = 35.88 \text{ RS Reading}$$

DWA Drug Index has moved up to 751 and the SPXEWI is now at 2110:

$$\frac{751}{2110} \times 100 = 35.59 \text{ RS Reading}$$

In this comparative example, both of these sector indexes moved higher in price along with the market, but only the DWA Retail Index improved on an RS basis. Said another way, the DWA Retail Index outperformed the market, while the DWA Drug Index slightly underperformed the market. Groups that are exhibiting positive sector RS versus the market are the ones to gravitate to when you're deciding which sectors to buy.

Sector Relative Strength Interpretation

When interpreting the sector RS chart, the process is basically the same as outlined previously. In like fashion, we are concerned with the most recent signal on the RS chart, and the most recent column the RS chart is in. Given

that sector RS measures how a particular sector is performing compared with the overall market and that sector is the greatest contributor to price fluctuation in a stock, it is imperative to evaluate this on an ongoing basis. (We can't emphasize this point enough.) Those sectors exhibiting positive RS versus the market are the ones to focus on for new buying. Sector RS buy signals are given when a column of X's exceeds a previous column of X's. But of equal importance for sector RS is what the most recent column is on the RS chart. This is the one slight difference in RS evaluation (compared with a stock's market RS or peer RS). When a sector index reverses up into a column of X's on its RS chart, we consider that to be a buy signal. Utmost attention is paid to column changes for sector RS because such a reversal will often be the beginning signs of a significant switch in sponsorship for the particular sector. We still regard the best reading for the sector RS chart as being on a buy signal and in a column of X's, yet recommend exposure to a group if its RS chart is in a column of X's.

Probably the most valuable aspect of sector RS is that it not only steers you to the sector(s) moving into favor, but keeps you invested in sectors that are market leaders, even if the sector(s) is considered overbought by other measures. To provide you with a little company history, this is one of the main reasons why we first started charting sector RS. In 1996–1997, the best-performing sector was the Banking/Financial group. This sector had performed very well in 1995, after bottoming out in fairly oversold territory. The group raced to an extremely overbought condition, as measured by the sector bullish percent chart (which you will learn about in an upcoming chapter) by October 1995. Member stocks, such as Citigroup and Chase Manhattan, recorded phenomenal gains during this time. Citigroup posted a 70 percent gain, while Chase Manhattan gained a remarkable 100 percent. But the up-move didn't stop there. Both Chase and Citigroup doubled in price during the 1996 to 1997 time frame. This is about the time when sector RS became an integral part of our technical research.

We became less enthused with the Banking sector in late 1995 because, as stated, the group was overbought. Our cautious approach to new recommendations in the group was, in hindsight, a mistake. But as we always endeavor to do, we learned from our mistake and developed our sector RS charts. In assessing the sector RS for the Banking sector, we realized that the group had been outperforming the market, hands down! The Banking group sneakily ascended to top-dog status despite being in the believed shadow of technology stocks. The lesson here—simple mathematics, in the form of division, can quantify and pinpoint outperformance if you are willing to

delve below the market's surface and evaluate the group's RS chart. In application, move to those sectors rotating into favor, stay with those sectors that continue to exhibit positive RS, and avoid those groups that turn negative on their sector RS charts (reverse to O's or break a previous bottom). Bottom line: if you hope to outperform the market, you had better be invested in those sectors with the best RS.

Examples of Sector Relative Strength Changes

To display the sheer power of Sector RS, let's take a look at a couple of examples. To do so, we will look at a group that relates to the previous chapter—Restaurants; but first, we will examine the Telecom sector, as it provides a classic example of the power of sector RS, for both entry and exit, at the height of the dot-com bubble. It helps to go back in time as we tend to experience different markets at different times. So let's turn the clock back to the turn of the century, the year 2000. As the new century was ushered in, investors' appetite for dot-com-related securities remained voracious, to the point of crazed "overeating" in this space. As we moved into the year, though, Dorsey, Wright & Associates (DWA) chose to push away from the dot-com table, in part due to the fact that AT&T (T) gave an RS sell signal in May 2000, along with the fallen angel, Worldcom. In other words, we noticed that cracks were starting to appear in the cement with respect to Telecom and Technology after what had been an unprecedented, parabolic up-move in these stocks and sectors. What is so amazing is how the Telecom sector RS chart quantified all this information, telling you that not only were there cracks in the cement, but that the whole house was starting to crumble and collapse.

As Figure 5.1 reveals, the DWA Telecom Sector Index gave an RS sell signal in April 2000 when it reversed into a column of O's. But prior to that, this RS chart was in a column of X's from January 1998 until April 2000. In other words, the RS chart supported a bullish, overweighted posture with respect to the Telecom sector, all while the group was rocketing into the stratosphere. Yet before returning to earth, the RS chart warned you and told you to "get out" in April 2000—and therefore, to underweight or avoid the Telecom sector going forward. Be it an individual stock, or an entire sector, notice how the RS chart positioned you to capture the large winner—indicating that Telecom was an area of outperformance from 1998 to 2000.

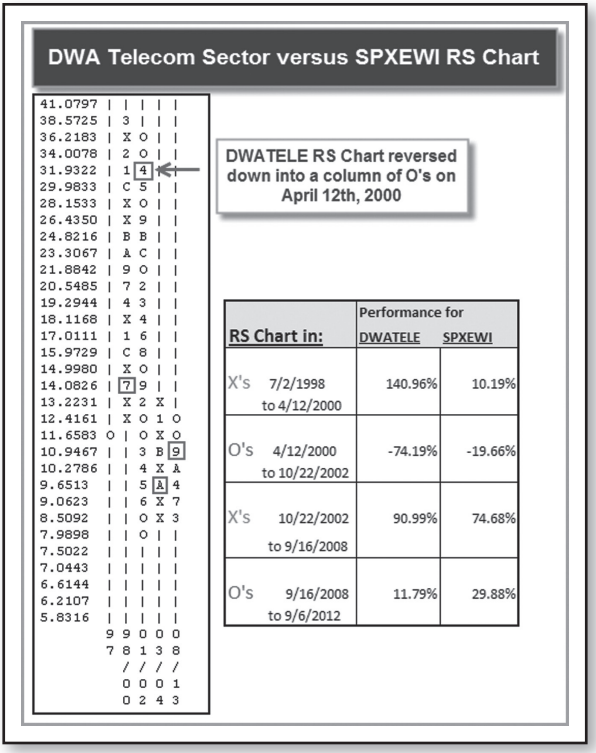


FIGURE 5.1 Sector RS: DWA Telephone Sector versus SPXEWI

The returns speak for themselves; the average Telecom stock, as measured by the DWA Telecom Index, posted a gain of 141 percent while in a column of X's, against a market return of 10.19 percent.

Conversely, when in O's from April 2000 to October 2002, suggesting underperformance, the RS chart steered your focus elsewhere allowing you to avoid a loss of 74.19 percent for Telecom. Sector RS, therefore, provides a very important piece of information in the decision-making process. While in X's, you look to buy the best stocks within that sector—those with the high technical attribute reading that are in an uptrend, for example. But when in O's, you are avoiding the group, and concentrating on stocks in other sectors. Not only are AT&T and WCOM noteworthy examples of this, but it was evident across the group. T basically doubled while on an RS buy signal in the late 1990s. But what about another popular name during this time period: Corning Inc. (GLW). GLW was up an astounding 236 percent while on a market RS buy signal during the 1998–2000 period,

yet fell a mind-boggling 97 percent after giving an RS sell signal in 2000. In sum, the carnage on a stock-specific basis continued from 2000 until the October 2002 bottom, yet the Telecom sector RS chart forewarned us very early on that there had been a change in season—summer had turned to winter for Telecom.

But as saying goes, "out with the old and in with the new." In 2000–2001, "new" literally meant the New York Stock Exchange–type stocks. Sectors such as Healthcare, Financials, Food & Beverage, and Building took the lead and assumed the role of outperformance in the market. Once again, the sector RS charts were able to broadly summarize this change in leadership, guiding those willing to look into "new" sector opportunities. One such glaring, but much overlooked, opportunity was in the Building sector; and this group maintained its grip on the leadership baton for a handful of years. But as previously stated, it is interesting how these sectors come into, but also move out of season. Building topped out in 2005–2006, then experienced a monumental slide for several years, while in the throes of the subprime lending/housing meltdown in 2007–2008. It was not until November 2011 that Building finally reemerged as a leader. In an otherwise lackluster market, Building jumped out as the place to be, for both absolute (trend) and relative (RS) reasons. As a result, we wrote extensively about this in our research reports, steering our clients toward this opportunity well before the mainstream media picked it up.

After every major market dislocation, such as that experienced in 2008 to early 2009, we typically see new leadership emerge. An RS theme that became the new "new" after this most recent market debacle was Consumer Cyclicals, specifically Restaurants and Retailing. In Chapter 4, we spoke of the RS improvement that we witnessed on an individual basis with respect to such stocks as Starbucks (SBUX) and DSW Inc. (DSW). Once again, though, the sector RS charts provided telltale signs that a positive change was afoot. The broad economic DWA Consumer Cyclical Sector RS and the DWA Retail Sector RS charts both reversed up into a column of X's on March 20, 2009, revealing to us that this space had become an area of outperformance, and therefore was one to have long exposure in. The Sector RS once again, in dispassionate fashion, told us and you the investor, when it was time to tactically maneuver into a "new" sweet spot in the market. Both of these RS charts have remained in X's for what are now 3½ years, and since giving their buy signals in March 2009, have registered substantial gains, as displayed in Figure 5.2.

FIGURE 5.2 **Consumer Cyclicals and Retailing RS Charts in X's since March 2009**

Sector Index	Symbol	Performance (%)
DWA DJ Consumer Cyclicals Index	DWADJCONCYC	150.69
DWA Retail Sector Index	DWARETA	304.70
S&P 500 Equal Weighted Index	SPXEWI	125.23

Another persistent area of strength within the broad Consumer Cyclicals has been found in Restaurants. The DWA Restaurant sector RS chart, shown in Figure 5.3, reversed up into a column of X's on May 17, 2010. Since that time, this sector has logged a gain of +52.04 percent, well outpacing the market, as measured by the SPXEWI, which gained +24.45 percent over the same time frame. So while the nightly newscasters lamented

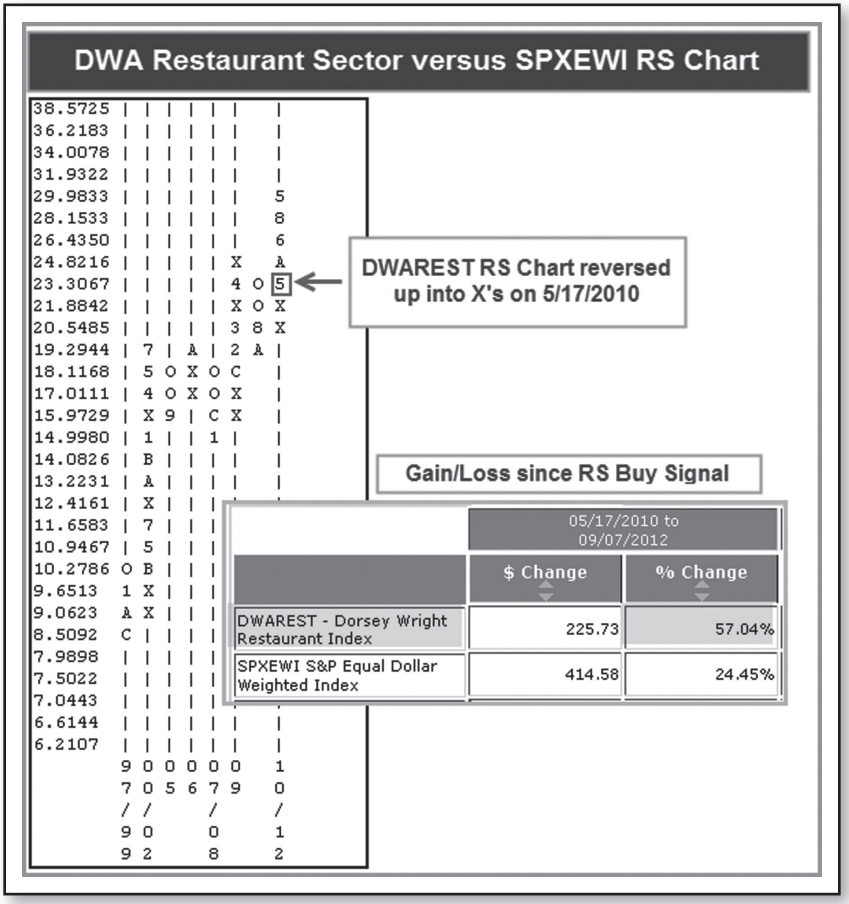


FIGURE 5.3 Sector RS: DWA Restaurant Sector versus SPXEWI

the specter of economic gloom and doom and recession, those sectors most associated with consumer spending forged ahead, and the RS charts all along have said "spend, spend, spend" your investment dollars here.

Sector Relative Strength Applied to Exchange-Traded Funds

In short, sector RS enables you to pinpoint those groups that deserve your investment dollars. One obvious course of action is to buy the stock(s) in a strong RS sector, which themselves possess positive RS versus the market and their peers. A good example of this would have been to buy Starbucks to gain exposure to the Restaurant sector. But due to the vast expansion in sector products via exchange-traded funds (ETFs), there are now many ways to garner sector exposure without having to stick with just one name. Instead, sector RS can be applied to a tradable vehicle that represents an underlying sector index—you get a basket of stocks in a given sector with a single ETF purchase. This allows you to avoid single-stock risk, while also providing instant diversification in one simple transaction. A caveat to this strategy is the "weighting" issue. As mentioned early on, our DWA sector indexes are equal weighted, whereas many ETFs are capitalization weighted. Therefore, a couple of stocks can be responsible for the bulk of the move in an index, so it pays to be aware of the makeup of each ETF before buying one. The best place on the Internet to do this is the Dorsey, Wright ETF web site, www.alletf.com. We will cover ETFs in more detail in a later chapter.

One way to use sector RS in conjunction with ETFs would be to merely buy an ETF based on the reading of a particular DWA Sector RS chart. In other words, if the DWA Healthcare Sector Index were in a column of X's on its RS chart, rather than buy a couple of individual stocks, you could buy a corresponding sector ETF, such as the iShares DJ US Healthcare ETF (IYH) or any of the other related ETFs that are now available.

Or why not just cut to the chase and analyze the actual RS of the ETF itself. If you think about it, this would provide a more "apples to apples" comparison—you would be measuring the exact RS of the vehicle that you are considering for purchase. And that is exactly what we do.

Sector ETF Relative Strength Calculation and Interpretation

On a daily basis, we calculate and plot RS readings for almost every ETF that trades in the U.S. The calculation mirrors that of sector RS on the DWA Sector Indexes, with one minor exception. Instead of having the S&P 500 Equal Weighted Index (SPXEWI) as the divisor, we use the Dow Jones U.S. Index, which trades as an ETF itself under the symbol IYY. This benchmark is used as the divisor because it is cap weighted and its approximately 1,300 members cut across large, mid, and small in capitalization groups. In other words, it tends to reflect how many of the sector ETFs are comprised. That being said, over the past few years, other providers, such as State Street and First Trust, have launched a suite of sector ETFs that are more equal weighted in nature. So when analyzing their relative strength, you may find it more useful to use the equal-weighted SPXEWI as the yardstick for the market.

In interpreting a sector ETF RS chart, it is exactly the same as what we laid out with DWA Sector RS—you pay most attention to the current column the RS chart is in. As with a stock's RS reading or a DWA sector RS reading, the ETF's suggestion/posture of outperformance or underperformance can last for years on end. For example, the Vanguard Information Technology ETF (VGT) has been in a column of X's, implying you should have long exposure to the sector, since March 2009—for over three and a half years. In fact, the average stay in a column for an ETF RS chart is approximately 500 days. In essence, it is an indicator that allows you to verify, in a succinct manner, the long-term trend of a sector ETF. In sum, when the sector ETF RS chart is in X's, it represents demand for the sector relative to the market, or it is an area of outperformance. On the contrary, when the sector ETF RS chart is in a column of O's, it represents supply is in control of that sector relative to the broad market, or that it is underperforming and therefore one to avoid or underweight.

Examples of Sector ETF Relative Strength

There have been a couple of notable themes encompassing the financial markets over the past number of years, namely, Energy during the first part of the decade, and then, as alluded to earlier, Consumer Cyclicals more recently. In the case of Energy, the RS chart allowed you to "strike oil" early on in the move higher, well before the mainstream media (and most investors) jumped

on the energy train. After capturing the bulk of this investment gusher, our RS work cautioned us in 2008 that something was amiss for this sector. This allowed us to step aside, helping us to avoid the cliff dive by the oil truck. Figure 5.4 depicts this RS chart guidance for the iShares Dow Jones U.S. Energy Sector Fund (IYE), an ETF that we recommended from 2002 to 2008 as a way to gain broad exposure to the energy-related stocks. Notice how this signal to be long energy lasted for six years, and during that time the IYE offered a gain of +212.77 percent, far outpacing the IYY return of +70.92 percent. This is a textbook example of how RS puts you in a position to capture the large winner—the positive outlier.

What is all the more interesting, pertaining to Energy, is how the mass media tried to sway the average investor out of Energy only a year into this positive RS condition. More specifically, *The Economist* magazine came out with a negative cover story on October 25, 2003, entitled "The End of the Oil Age," and depicted a desert condition with two dilapidated gas pumps. Mr. Jones would have seen this bearish cover story, and would have screamed, "Get me out of anything related to crude oil!" However, the bullish stance on Energy lasted another five years, with the IYE RS chart impartially telling you to maintain exposure in the Energy sector (allowing you to capture a big winner).

The other, more recent theme that has been consistently in place for years now, and which we previously discussed with sector RS, is that of Consumer Cyclicals. We now want to turn our attention to a subset of this broad group, though, and show you how relative strength would have, in an unbiased respect, pushed you toward an ETF in the Retail sector. Despite the woes of recession, the cash register has been ringing a happy tune for several years now. The SPDR S&P Retail ETF (XRT) reversed up into a column of X's as early as February 17, 2009. In fact, it was the Retail sector that was one of the early leaders that rose out of the ashes of the 2008 fire sale. To this day, the XRT remains in X's, a testament to its persistently strong state of outperformance over the market. Putting numbers to this we find that the XRT has logged an impressive gain of 229 percent so far, leaving the IYY on the rack with a mere gain of 89 percent.

FIGURE 5.4 **IYE RS Chart in X's from October 2002 to September 2008**

Sector Index	Symbol	Performance (%)
iShares Dow Jones Energy Sector Fund	IYE	212.77
iShares Dow Jones U.S. Index Fund	IYY	70.92
S&P 500 Equal Weighted Index	SPXEWI	107.60

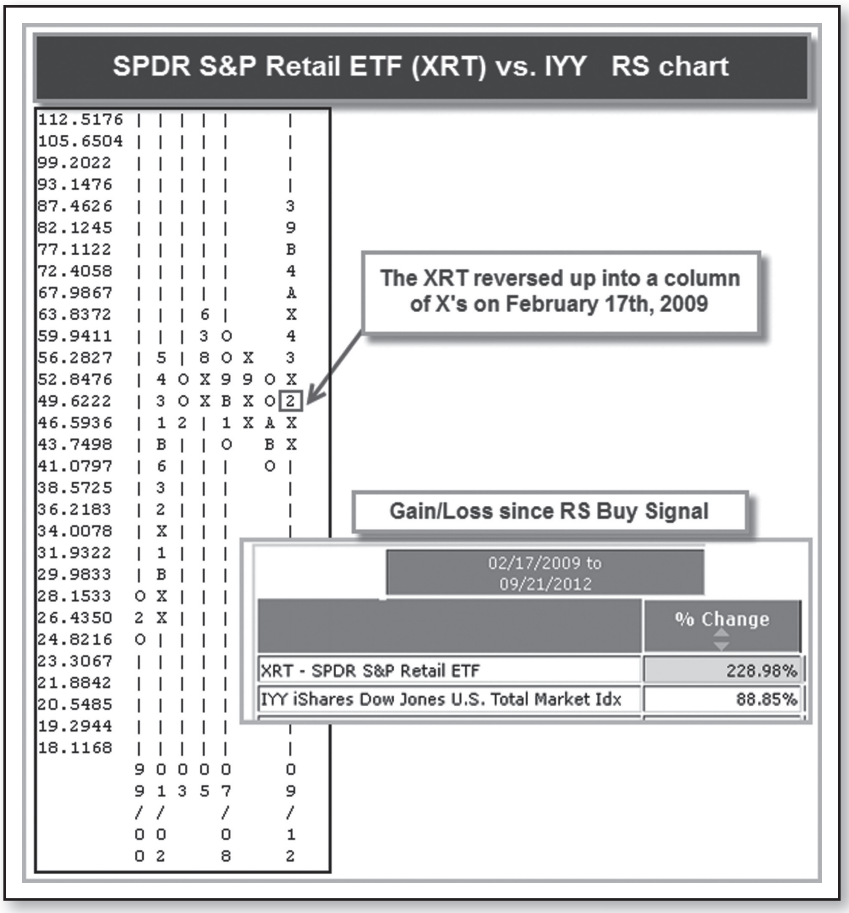


FIGURE 5.5 ETF Relative Strength: SPDR S&P Retail ETF versus IYY

Just as a sector ETF's RS chart will point us toward opportunity, as it did with Energy, and more recently with Retail at the bottom in early 2009 (see Figure 5.5), it can serve to warn us of an impending problem. Such was the case with Technology in 2000, and it serves as a textbook example for the annals. I like to go back 12 years on this because it was such a momentous occasion. You had to live through the dot-com craze to have a real feel for it. In the 1990s, technology, dot-com stocks—anything Internet related—all did unbelievably well. Even Hanes Corporation went up significantly when it said it would sell its underwear online! Virtually everyone was invested in something technology. Doctors gave up their practices to enter the day-trading world. It was simple—you just bought a technology stock and it went straight up. Money grew on trees. That is, until it didn't—the money

tree shed its leaves. The crash was merciless. No one could believe it was happening, especially the media, who kept on hyping it. I remember being interviewed on CNBC about Dell Computer and I said to sell it. When I got back to my office, I had some very unkind e-mails waiting for me. At that time, everyone, it seemed, had a vested interest in DELL's staying up. This was the all-time great performing stock. It split 2 for 1 six times from 1995 to 1999. On a postsplit basis, the stock topped out at $55 in February 1999, and today it's at $11. Our RS work identified, on many different levels, that the "tech bubble" was bursting. Recall our earlier points made on AT&T, WCOM, and the DWA Telecom sector. In those instances, the RS charts revealed worrisome technical developments. This same phenomenon was witnessed in the ETF arena, too. In a broader respect, the RS chart of the iShares Dow Jones U.S. Technology Sector Fund (IYW) experienced a reversal into a column of O's on April 14, 2000. After having been in X's since September 1998 and what amounted to a monstrous rally, this RS chart was advising us that it was time to depart the broad Technology sector. All told, this was another example of how RS got us in, but then out of harm's way. Surely, you can now guess what the magazine cover stories were like in April–May 2000. Yep, John Chambers's (CEO of Cisco Systems) picture was plastered all over *Fortune* and *Worth,* counseling you to "buy his stock." Thereafter, Cisco Systems' stock price fell precipitously from 75 to 8.50, or roughly 88 percent!

Drilling Down: Subsector Relative Strength

Before leaving the topic of sector RS, we want to briefly touch on one more aspect of it. In particular, we want to demonstrate to you how you can "drill down" below the surface of a broad sector, such as Consumer Cyclicals, to pinpoint specific subsector strength. This can be extremely helpful when trying to determine where best to allocate your dollars within a given sector. As we have demonstrated, one way to do this is to merely buy a representative proxy (ETF) for a sector when the RS chart is in X's, such as the IYE for Energy exposure or the iShares Dow Jones U.S. Consumer Services Sector Fund (IYC) for broad exposure to the Consumer Cyclicals. But underneath the broad surface of Cyclicals, there emerged a more compelling story in November 2011.

There are subsectors that comprise each broad industry group, and in the case of Consumer Cyclicals, there is a subsector known as "Home

Construction." Basically, this subgroup is made up of homebuilders—the much maligned segment of this broad group that was left for dead, for years following the mortgage lending meltdown of 2007–2008. And although Restaurants and Retailers deserve their kudos, it has been these Cyclical brothers and sisters that truly deserve a "gold star on the forehead" for their performance in 2012. The DWA Broad Economic Sector Tree, which is available on our web site, displays with one quick snapshot, those subsectors that possess positive RS, as denoted by the green shading; you will notice that Retailers, Restaurants, and Home Construction, among others enjoy this preferred status.

Figure 5.6 brings this to light in a way as obvious as the little kid with her hand raised in class, saying, "Oh, oh pick me, pick me, please!" On November 30, 2011, the DWA Home Construction Sector Index (DWADJHOMECONST in our database) reversed up into a column of X's on its RS chart (versus the S&P 500 Equal Weighted Index), advising you that a new leader was emerging

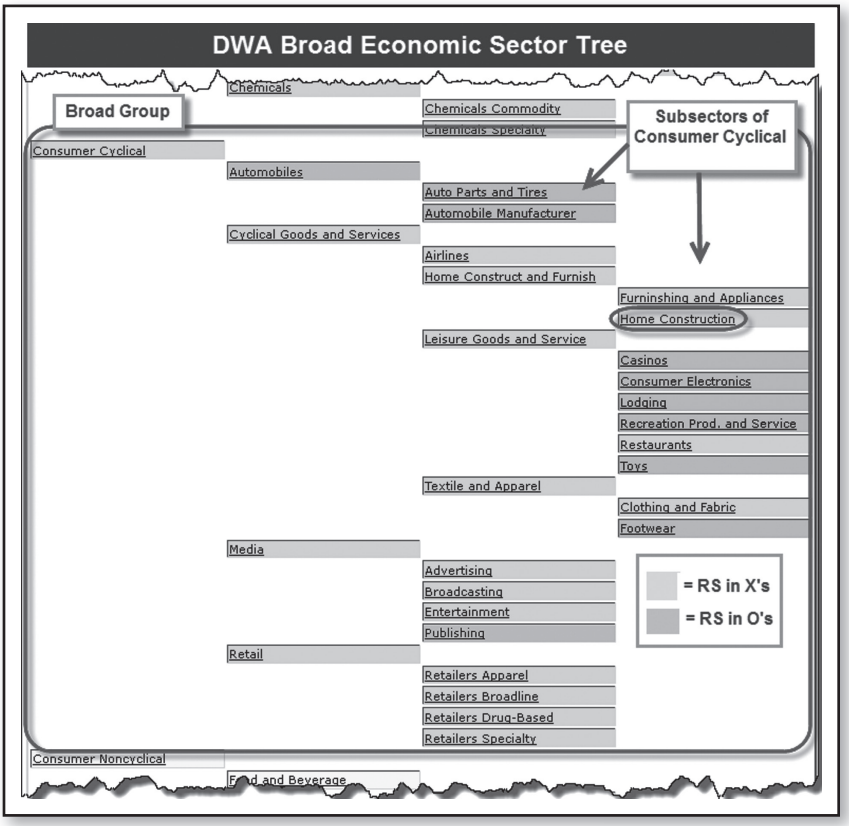


FIGURE 5.6 Subsector RS: DWA Broad Economic Sector Tree

within the broad Consumer Cyclical group. Not that you had to eschew the Retailers, but instead your horizons could be broadened within the broad group. Homebuilders such as D. R. Horton, Inc. (DHI), Lennar Corporation (LEN), and Meritage Homes Corporation (MTH) all had become worthy contestants, deserving your investment dollars. The returns, as illustrated by Figure 5.7, have been staggering since the RS buy signal pinpointed outperformance in late November 2011. For instance, LEN is up an amazing 103.75 percent and MTH has vaulted 93.63 percent. What makes this story compelling is that during this time, what is now close to a year, the IYC is up 24.40 percent, handily beating the market (SPXEWI) with its gain of 14.61 percent, confirming the sustained strength of this broad group. But without a doubt, for those willing to graze in a new pasture and buy individual homebuilder names, this Home Construction subsector RS chart is a prime example of the benefit of "drilling down" in order to itemize specific areas of outperformance. Taking it one last step, realize that with the vast array of sector ETFs available, investors could have taken this information and with one-stop shopping could

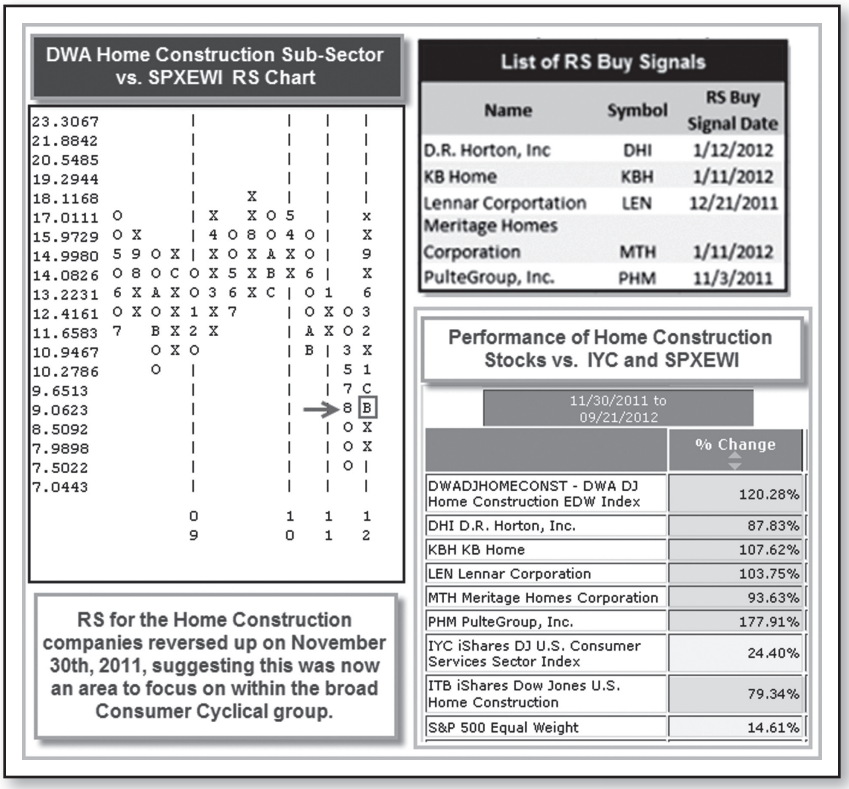


FIGURE 5.7 Subsector RS: DWA Home Construction Index versus SPXEWI

have bought a basket of homebuilders with the iShares Dow Jones U.S. Home Construction ETF (ITB). As the numbers show, penthouse-like returns have been garnered so far—since the November 30, 2011, RS buy signal, the ITB has gained 79.34 percent.

This particular use of RS can be applied to any subsector or mini-sector, with the calculation and interpretation of the chart being the same as that outlined with sector RS. It allows you to find specific niches of strength, and therefore enables you to position yourself in that defined area. It is particularly useful when analyzing the very large broad industry groups such as Consumer Cyclical, Healthcare, Industrial, and Financial. This is just one more arrow to put in your quiver when determining which sectors are in season and which are not.

Relative Strength Applied to Asset Classes

Sports fans know that the three worst words a batter in baseball can recite to himself upon approaching the plate are "don't strike out." So it should be no surprise that "investing to avoid losing money" will be as hopeless an activity as "batting to avoid striking out." Put in investment terms, people crave safety—yet they desire high returns, so they invest in the stock market anyway. But how? By buying (and often holding) "safe stocks," or at least ones they perceive to be safe, such as General Electric (GE), Coca-Cola (KO), Wal-Mart (WMT), Merck (MRK), Intel (INTC), General Motors (GM), and Microsoft (MSFT). The point of all this is, as an investor, you must take whatever returns the market is offering. Over more than a decade, it hasn't been with the blue-chip, "safe," large-cap stocks. In fact, this tilt toward a "large-cap" phenomenon has only played out in 2012. Putting some numbers to this, in 1998 Coca-Cola hit a high of $44, and it still has not gotten back to that level. MSFT hit a high of $37 in 2007 and it's still ten points below that level. GM hit a top of $39 in 2011 and it's been straight down from there, and that's after the government bail-out! Wal-Mart, on the other hand, has been a decent performer. It reversed up on its RS chart versus the broad market on August 19, 2011, and has beaten the broad averages significantly since then, and that has been hard to do over the last year or so. The point is that you have to pay attention and must go to where the strength resides. Remember, to the extent that you try to seek return where there is none, you create risk. In my opinion, it's actually less risky to go with the flow and follow the returns wherever they may be in the market.

Relative strength has yet another application—determining which asset class to overweight or emphasize; and within an asset class such as Domestic Equities, which market cap and style should be overweighted. As alluded to earlier, RS has placed us in the right segment of Domestic Equities, with respect to market cap, for many years on end; and in particular has told us to steer our clients toward small cap for the better part of the last decade. In Figure 5.8 you can see this type of RS at work. In this example, we compare the S&P 600 Small Cap Index (SML) to the S&P 500 (SPX)—or David (small cap) pitted against Goliath (large cap). The calculation here is the same as instructed before, easy division:

$$\frac{\text{SML Price}}{\text{SPX Price}} \times 100 = \text{RS Reading}$$

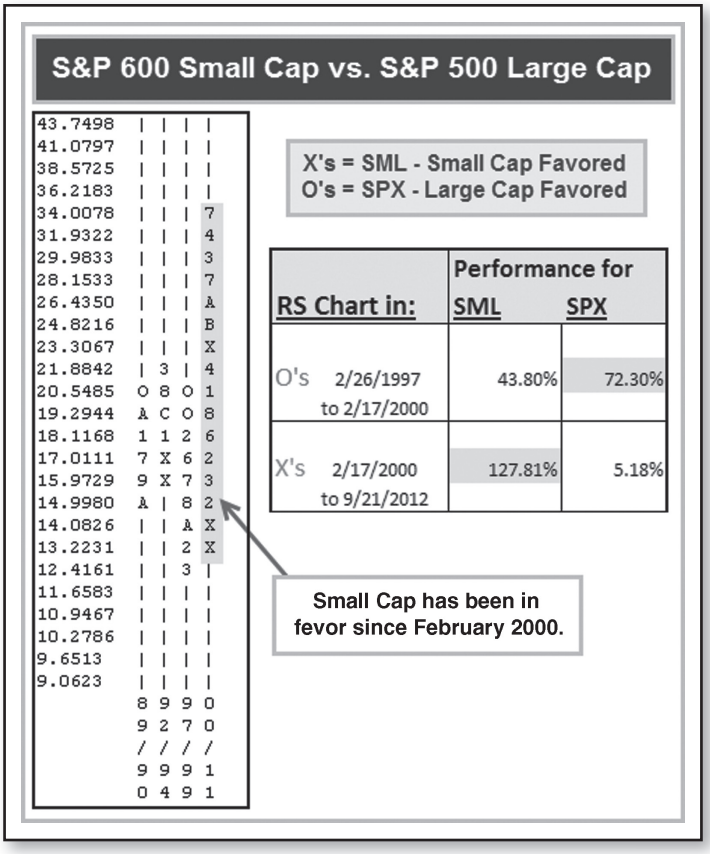


FIGURE 5.8 RS within Asset Classes: S&P 600 Small Cap Index vs. S&P 500 Large Cap RS Chart.

The interpretation of the chart is similar to that of sector RS, in that we place most importance on the current column. The investor should overweight small-cap stocks at the expense of large-cap stocks when in a column of X's (indicating outperformance), and should underweight small-cap stocks when the chart is in O's (suggesting underperformance). As you can see, this particular RS chart has been in a column of X's since February 17, 2000—for over 12 years. Simply stated, it has unmistakably told you to emphasize small-cap stocks and to throw stones at Goliath (large-cap stocks). The returns speak for themselves, with the SML gaining 128 percent during the past 12 years while the SPX gained 5 percent. Yes, only 5 percent! Literally, one major switch in your portfolio 12 years ago would have made a monumental difference in the returns seen since then. Unfortunately, many investors stayed married to their large-cap, blue-chip stocks, failing to live by the aforementioned phrase of "until RS do us part." When you see CNBC interviewing a money manager who has done well for a long time, it is generally due only to the particular style he manages coming into vogue. His doing well is as much a surprise to him as it is to the investing world. I was co-host with Mark Haines on CNBC once and we interviewed a small-cap mutual fund manager. I asked him what his plans were when his asset class he managed once again fell out of favor as it had done a few years earlier. His response was that he only sold stocks when they reached 80 percent of their fundamental value. In other words, he had drunk the Kool-Aid. He really believed his returns were due to his fundamental work.

This type of RS can be used for more than just market cap determination. It is also helpful for discovering where to be with respect to style allocation—such as value versus growth, and whether or not to equal-weight or capitalization-weight your portfolio. With the explosion in the number of market ETFs now available, determining these types of relative strength can be useful and easily implemented. For example, you could put market cap and style together and compare the iShares S&P Small Cap 600 Value Index Fund (IJS) versus iShares S&P 500 Growth Fund (IVW).

Relative strength is equally beneficial to use for tactical asset allocation decisions. In keeping with a top-down approach to investing, one of the first things to determine is whether you should be overweighting or underweighting a given asset class. For example, is Domestic Equities in a condition of outperformance or Fixed Income; or what about Commodities? It is necessary to know this, as it allows you to make key macro decisions with respect to your asset allocation. One chart that we regularly turn to for

this task is an RS comparison between the S&P 500 Index (SPX) and the Barclays Aggregate Bond Index (AGG). This one simple exercise provides us with a very "measurable" benefit. As Figure 5.9 displays, we can take our cue from the RS chart that has the SPX as the numerator and the AGG as the denominator. When the RS chart is on a buy signal, it favors overweighting Equities compared to Fixed Income, and when on a sell signal, it suggests you are better off allocating your dollars toward Fixed Income. As the data shows, the RS signals have been very prescient, and if we were to use an RS switching concept with this one simple chart, meaning that you are *either* invested in bonds (as measured by the AGG) *or* are invested in equities (using the SPX), we find that the returns far outpace simply buying and holding either the SPX or the AGG.

By using RS to "tactically maneuver" within the confines of a traditional strategic asset allocation pie, you put yourself in a position to become a consistent hitter, and even hit an occasional home run, rather than going to the plate hoping you don't strike out! Think about this for a second. If you are an investor and walk into a brokerage office today, you will more than likely be met by an adviser who strictly uses modern portfolio theory.

RS Signal History: S&P 500 vs. Barclays Bond Index

RS Signal: Buy = Outperformance of Equities to Fixed Income
Sell = Underperformance of Equities to Fixed Income

Start Date	End Date	Signal	SPX	AGG
11/22/00	7/31/03	Sell	- 25.11%	23.16%
7/31/03	7/15/08	Buy	22.68%	1.84%
7/15/08	6/5/09	Sell	- 22.62%	- 0.69%
6/5/09	9/21/12	Buy	55.32%	11.87%

Buy and hold SPX:	10.42%
Buy and Hold AGG:	39.35%
Switching:	133.06%

FIGURE 5.9 Asset Class RS: S&P 500 Small Cap Index vs. Barclays Aggregate Bond Index RS Performance Data

He will sit you down, ask you some questions, and determine your risk level, whether aggressive, moderate risk, or conservative. Here is a clue: we are all moderate until the market rises, then we become aggressive, and when the market declines, we become risk averse. His computer will then give you a suggested strategic asset allocation pie. Next, he will tell you they will rebalance your portfolio twice a year. Rebalance is a great buzzword. We all want to be rebalanced if we become out of kilter. But by using RS to determine when you should tactically alter your strategic allocation, you place yourself in a position to be in the right asset classes at the right time. So in 2008, one simple RS chart would have steered you to an underweighted equity posture, yet pushed you back into equities in June 2009.

Before moving on, I want you to take a minute to reflect on what we have discussed so far with respect to RS, and in particular I want you to recall the examples we have used throughout this chapter and the previous one. As you go forward in your investment endeavors, I implore you to step back and "observe" what is going on. By observing, you will know. Therefore, knowing is believing, and believing gives you confidence. That big "C" word, *confidence,* is the key to it all.

Using Relative Strength to Determine International Exposure

We have all heard the phrase, or have read (to our kids) the book known as *Where's Waldo?* The book appeals to the reader, asking, "Have you found Waldo yet?" The reader basically goes on a quest, wondering where in the world is Waldo, trying to determine what new place he has traveled to now. Well, I ask you in investment terms, "Do you know where in the world there is outperformance?" The answer once again lies with RS. Relative strength can determine what new place should garner your attention with respect to your global or international exposure.

In keeping with our earlier discussion regarding the standard strategic asset allocation pie, there is typically a slice or portion of the overall portfolio allotted to international equities. But, often, this slice takes a backseat, as many investors just don't know how to go about making decisions dealing with the international markets. The good news is that you have an investment map in the form of RS right at your disposal. This map will not only tell you "where in the world" to be, but will also let you know if you should

be cutting a bigger piece of the international pie (overweighting or underweighting your exposure to the global markets).

To chart our international course, we use RS in a couple of different ways. First, we can compare the broad overseas markets to the domestic, U.S. market. This will tell us whether the overseas markets are exhibiting positive RS compared to the United States, and therefore prompt us to allocate more or less money to the global markets. Once we know whether or not to gain international exposure, we then can use RS to determine which regions or countries actually deserve our investment dollars. In this exercise, we would literally compare one region to another or one country to another—such as Europe versus Latin America or Japan versus China. The calculations, therefore, are the same as those previously learned—you are merely dividing one security by the other, then multiplying by 100.

Got Global? Measuring Overseas versus United States

It has only been recently that investors have gotten an appetite for foreign investment. But if you look at the RS chart of the EAFE Index versus the Standard & Poor's (S&P) 500, it would have petitioned you to travel abroad much sooner – that is up until 2008. The EAFE Index from Morgan Stanley Capital International is designed to measure the overall condition of the overseas markets—Europe, Australia, and the Far East. There is an ETF benchmarked to this index, offered by iShares, that trades under the ticker EFA. Figure 5.10 reveals how the EFA was the better performer, traveling in first class, from September 24, 2003, until August 8, 2008, for almost five years, while the S&P 500 (SPX) was relegated to the coach seats. During this time, EFA well outpaced the SPX, gaining 68.29 percent against the S&P 500's return of 28.43 percent. Moreover, just a year after this RS reversal to X's (favoring EFA), *The Economist* magazine boldly stated on its cover of October 2, 2004, "Scares Ahead for the World Economy." This provided us with all the more conviction that pulling the passport out and going global was the right trip to take, up until mid-2008. But as we turned the page to a new decade, we have been guided to fly back to the United States. Since April 22, 2010, domestic equities has been the preferred destination, and that remains the case today. It truly is uncanny how RS has steered us away from international markets, all while the Eurozone crisis rages on.

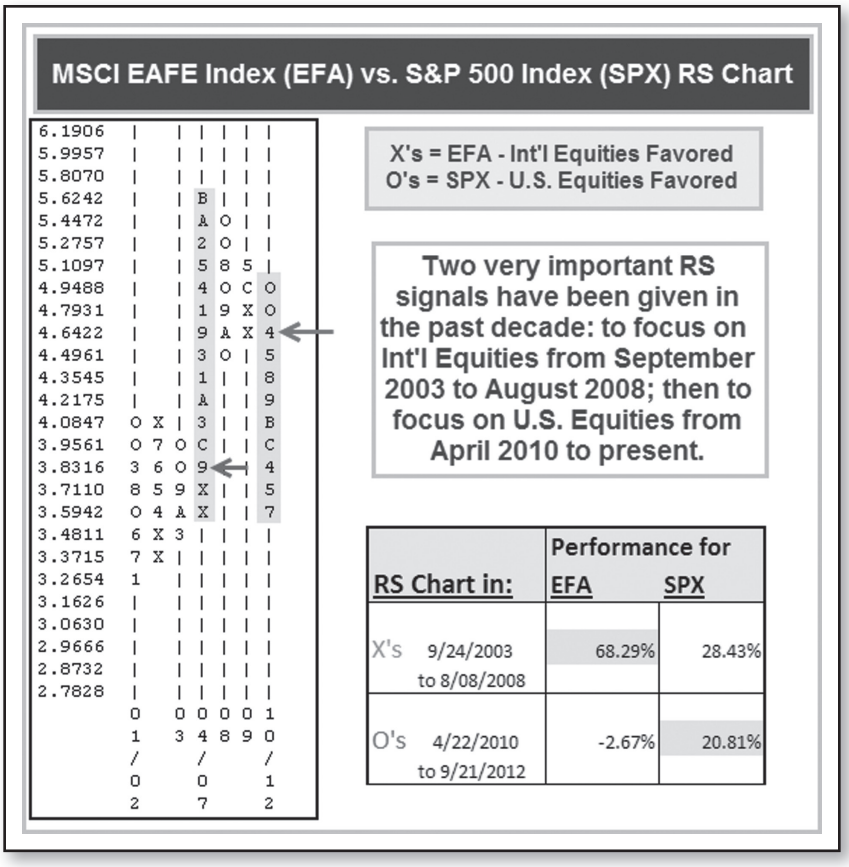


FIGURE 5.10 Got Global? Measuring Overseas versus United States: EFA vs. SPX RS Chart

Where in the World to Be?

To delve a little deeper, RS can be very helpful in zeroing in on those areas or countries that are fueling the international economy. In other words, RS can tell us our precise travel itinerary. Granted, the EFA is an excellent and easy way to broadly allocate your global slice of money, but as Figure 5.11 shows, there is alpha to be grabbed if you are able to pinpoint region or country outperformance.

When determining where you should travel to with respect to specific region or country, we use RS, but in a slightly different application. Of course, one way to expose specific outperformance would be to compare each region or country to the EAFE Index, similar to

FIGURE 5.11 **Where in the World to Be?: International Region/Country Performance Compared to EFA**

International Region/Country	Symbol	Gain/Loss (%) September 2003 to August 2008
iShares MSCI EAFE Index Fund	EFA	68.29
iShares S&P Latin American 40 Index	ILF	380.26
iShares MSCI Emerging Markets Index	EEM	167.66
iShares MSCI Brazil Index Fund	EWZ	500.24
iShares S&P Europe 350 Index Fund	IEV	70.47
iShares MSCI Japan Index Fund	EWJ	31.86
iShares MSCI Malaysia Index Fund	EWM	66.95
iShares MSCI Australia Index Fund	EWA	104.09
iShares FTSE/Xinhua China 25 Index	FXI	226.20
S&P 500	SPX	28.43

evaluating a sector versus the S&P 500 Equal Weighted Index. But another way to establish this type of outperformance is by pitting a region or country against another—Europe versus Latin America, for example. We discuss this topic and its portfolio applications in greater detail in Chapter 10.

As you become skilled at plying the investment waters, you can also see how RS can help you to effectively reach distant shores; portfolio management need not be relegated just to U.S. soil. And when asked, "Where's Waldo?," you'll know the answer.

Mutual Funds: The Same Relative Strength Tools Apply

By definition, a mutual fund is an open-ended fund operated by an investment company that invests in a group of assets in accordance with a stated set of objectives. Two of the main benefits of a mutual fund are that it provides diversification and professional money management. The choice of funds available to the investor is staggering, including such types as sector, income, growth, fixed income, blend, tax-free funds, and so on. In many respects, a mutual fund is similar to an ETF, in that both are buying a basket of securities and provide diversification by doing so. But there are a few notable differences: most ETFs are unmanaged while mutual funds are

managed, ETFs are transparent while mutual funds do not readily expose their holdings; and ETFs typically have a lower expense ratio compared to the fees of a mutual fund. Each have their pluses and minuses, but differences aside, the mutual fund industry is still the behemoth in the "fund" marketplace with respect to assets under management, despite the considerable progress seen in the ETF world. I surmise, though, in the years ahead this may well change.

Given this mammoth presence, it is worth spending a few minutes discussing how RS can be used with mutual funds. In a nutshell, the same RS tools you have already learned about can be applied to a mutual fund. The calculation is the same, too, in that you divide one security by the other and multiply by 100. For example, we calculate how a mutual fund is performing versus the market, as measured by the SPXEWI. This basically provides you a measurement of outperformance or underperformance along the same lines as sector RS. We use the SPXEWI instead of the IYY because most mutual funds are closer to being run on an equal weighted basis, compared to most ETFs which are often skewed by their cap-weighted construction. The interpretation of a mutual fund RS chart is similar in that RS is said to be "positive" if the chart is on a Point and Figure buy signal. But the best RS reading is when the chart is on a buy signal and in a column of X's. One difference in interpretation lies in addressing the volatility of the given fund. Sector funds are typically evaluated using the RS signal, whereas lower-volatility, broad asset class mutual funds are, as a rule, judged by the most recent RS column. Everything we discussed above with respect to RS calculations and comparisons can be done with mutual funds. Simply use the mutual fund symbol to do the comparisons. For example, you can analyze the Fidelity Select Energy Service (FSESX) mutual fund compared to the SPXEWI.

Mutual fund RS can be used in other ways previously discussed. For instance, not only could you evaluate how the American Funds Growth Fund (AGTHX) is doing relative to the market, but you could also assess how one fund is performing versus another, such as AGTHX compared to Dodge & Cox Stock (DODGX) fund. This would provide you with an RS comparison along the lines of market cap and style RS discussed earlier. In the case of AGTHX versus DODGX, the RS chart would tell you whether the large-cap growth fund has the upper hand, or whether the large-cap value fund deserves your investment dollars.

The Fund Score

With respect to mutual funds, we have devised a technical ranking method or fund score. This score is similar to the Positive Technical Attribute reading for stocks that was discussed in the previous chapter. Just as the positive technical attribute reading provides a concise summary of a stock's technical picture, so does the fund score for mutual funds (and ETFs). In both cases, these ranking methods provide the investor a speedy way to work through and evaluate a large inventory of stocks or funds.

The fund score, as a rating system, ranges from a reading of 0 to 6. The score includes the five basic positive technical attributes, similar to how we rate stocks; yet the fund score also includes more parameters, which take into account chart patterns, moving averages, momentum, and percentile ranking for the fund versus several market and peer groups over several time periods. The score uses proprietary weightings but adds up to reflect one third trend chart attributes and two thirds RS attributes, as illustrated by Figure 5.12. Our fund score rating system is geared more toward evaluating the current market conditions, which differs from other mutual fund ranking systems that focus on a longer time period; this longer period may not have pertinence or can be inflexible for making beneficial investment decisions. In general, you want to focus your buying on those funds that have a fund score of 3 or higher. Of course, those funds that possess a score of 5 or above are exhibiting phenomenal trend and RS characteristics, and should pique your interest most when working through and evaluating a large inventory of funds to purchase.

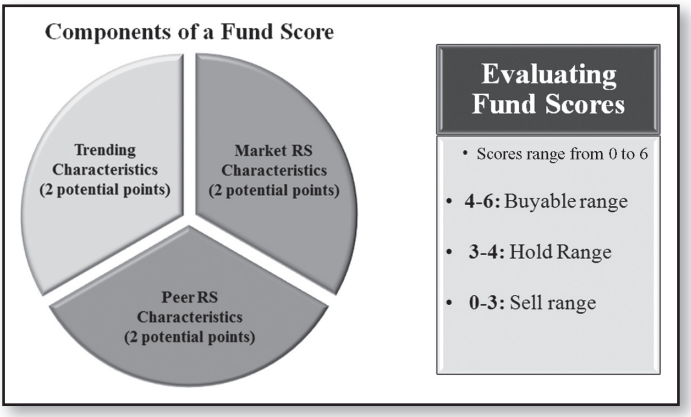


FIGURE 5.12 Mutual Fund Relative Strength Tools: Fund Score Rating System for Funds

Stock versus Stock Relative Strength

Throughout this chapter, I have displayed for you a multitude of ways that RS can be used to help make investment decisions. Most of what we have covered so far has dealt with broader questions pertaining to asset class, style, sector, ETFs, and mutual funds. But now I want to show you how RS permits you to pinpoint in a very refined way whether one stock is a better choice over another, on a relative basis.

This type of comparison can be very helpful in a couple of ways. For example, you may have a fundamental list of stocks that you like to use as an inventory of ideas. Let's assume that you want to gain exposure to the health care sector, and your fundamental list has two health care stocks to choose from, but you only want to buy one. How do you choose which one to purchase? One simple answer would be to create an RS chart comparing the two stocks. By doing so, it would tell you, very matter-of-factly, which stock was performing better, giving you the proper information to make your decision.

Also, stock versus stock RS is extremely beneficial when you are trying to narrow a list of strong, technically sound stocks down to only a couple of names. For example, let's say that you wanted to purchase a Steel & Iron stock to take a Metals position. You have narrowed the list down to two stocks that both possess a 5 (for 5) positive technical attribute reading. In other words, both have exemplary RS and trend characteristics. Which one do you buy? If you pit one against the other in an RS arm-wrestling match, there will be a clear winner. The RS chart will quantify which one is outperforming the other, giving you the correct answer of which to buy.

The Pepsi Challenge, Taste Buds Aside

The Pepsi Challenge in a formal sense has been an ongoing marketing promotion run by PepsiCo (PEP) since its introduction in the mid-1970s. The challenge takes the form of a taste test. At malls, shopping centers, and other public locations, a Pepsi representative sets up a table with two blank cups, one containing Pepsi and one with Coke. Shoppers are encouraged to taste both colas, and then select which drink they prefer. Then the representative reveals the two bottles so the taster can see whether they preferred Coke or Pepsi. A taste test such as this will help you discern which cola pleases your palate, but it surely doesn't help you decide which cola com-

pany's stock deserves your money. Yet an RS chart is one way to see how investors are voting their wallet, regardless of taste buds. In Figure 5.13 you can see that since October 1999, Pepsi has had the upper hand compared to Coca-Cola (KO). PEP has "beat the Real Thing," handily outperforming KO, gaining 105.67 percent since 1999, while KO has gained half as much, rising 51.16 percent. So while KO may possess the more dominant market share of cola drinkers, or may be your preferred soft drink based on taste, PEP has been more dominant in the stock market on a long term relative basis.

A stock-versus-stock RS assessment can be helpful with specific purchase decisions, yet it can also be very beneficial for those traders or investors that like to construct "pairs trades." An advanced trading strategy such as this consists of buying one stock and shorting the other, and typically is done within one specific sector. So in using the RS information with respect to Pepsi and Coca-Cola, it would suggest that you buy PEP shares and short KO shares. The idea here is that you purchase the stock with the stronger

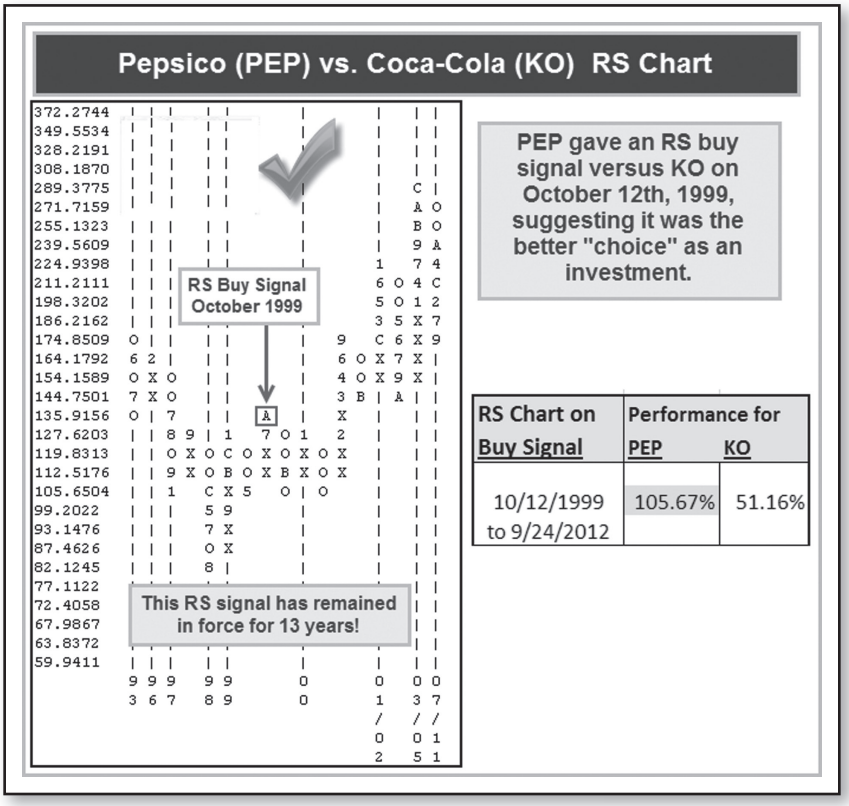


FIGURE 5.13 Pepsi Challenge: PEP versus KO Relative Strength Chart

RS, with the idea that it should rise faster than the stock with the negative RS. The best-case scenario in this situation, then, is that the stock you buy goes up in price while the stock you shorted falls in price. As a sidebar, in addition to a stock-versus-stock RS chart, other technical criteria can be brought into the equation when developing a pairs trade. For example, you can consult the positive technical attribute reading for each stock, with the long side of the trade focused on a stock in an uptrend with a 3, 4, or 5 for 5 reading, and the short side geared toward a stock in a downtrend with a 0, 1, or 2 for 5 ranking.

Relative Strength Matrix Concept

In our previous discussions, we have suggested that RS is really nothing more than an arm-wrestling match—pitting one opponent against the other such as Hulk Hogan versus Jesse "The Body" Ventura. The RS match determines which security gets its arm raised, declaring it the winner. Ultimately, such a match shows where outperformance resides, and gives you important information to make your investment decisions.

DWA Relative Strength Chart Matrix

In an effort to constantly make our research better for our clients, we have taken this arm-wrestling match concept and put it in the form of a big round-robin tournament. More specifically, we developed the DWA RS Chart Matrix. In our first iteration of this concept, we created an RS chart for every sector against every other sector using our 40 DWA equal dollar-weighted sector indices. This allows us to identify the strongest sectors relative to all others. For example, the Aerospace sector would have 39 RS charts, one against Autos, Banks, Biotech, Buildings, and so on. In addition to the sectors, we also include an RS chart versus the SPXEWI. This means that each DWA sector index has a total of 40 RS charts. Realize it is still the same type of calculation: dividing the closing price of one DWA sector index by another DWA sector index. In addition, the RS reading is still plotted on a uniform percent scale, but for these RS charts we use a smaller box size, or scale, than the standard. We wanted to "speed up" the charts in order to key off of signals rather than columns, but still not produce whipsaws.

But how do we possibly display and make sense of all of these RS charts? To do this we created the "DWA RS Chart Matrix." In this table, we placed the sector symbols horizontally across the top and vertically down the left side. The sector on the left side of the table is the numerator in the RS calculation and the denominator is defined along the top. As you move to the right of the symbol (numerator), the cells of the table are populated with the status of the RS chart versus the sector in the top row. "B" indicates the RS chart is on a buy signal and "X" indicates the RS is in a column of X's. An "S" indicates an RS sell signal and "O" indicates the RS chart is in a column of O's. Remember, an RS chart that is on a buy signal and in X's suggests that the sector on the left side of the table (numerator) is very strong and is outperforming the denominator on both a long-term and short-term basis.

All told, there are over 1,600 cells in this table or matrix. So how on earth can you "get your arms around" this huge wrestling tournament? To help quantify all this information, we implemented a simple ranking of the sectors. It is based on the total number of RS charts that are on a buy signal for a given sector. We tally the total buys for each sector and the one that has the most is ranked as number 1. For the sector with the lowest number of buy signals, it is ranked as number 41. If two or more sectors have the same number of buy signals, the tie is broken based on the ones that have the most RS charts in a column of X's.

When applying this to your portfolio management, you obviously want to concentrate your buying on those sectors that are at the top of the matrix as they are the ones that are outperforming the most sectors. It is these sectors that have been able to win the most RS arm-wrestling matches against their sector opponents. All told, the DWA RS Chart Matrix provides you another way to evaluate sector RS, and allows you to know which sectors to overweight, while also letting you know which sectors don't deserve your attention. A sample of the DWA RS Chart Matrix is shown in Figure 5.14; this matrix would suggest that you focus your buying on those sectors toward the top, such as Building (BUIL), Retailing (RETA), Restaurants (REST), Precious Metals (PREC), and Biotech (BIOM). Conversely, those sectors with the worst overall RS compared to other sectors would be Metals Non-ferrous (META), Electronics (ELEC), Wall Street (WALL), Telecom (TELE), and Steel & Iron.

So what about the validity of using the RS matrix concept for investment decisions? The general rule of thumb in applying the matrix concept to portfolio construction is to focus your buying on those sectors or securities in the top quartile of the matrix, and holding those positions until the sector

Rank	Ticker	Buys	Xs	Tot Combo	Tech Attrib/ Score	DWAMETA	DWAELEC	DWAWALL	DWATELE	DWASTEE	DWASEMI	DWAOIL	DWATRAN	DWAOILS	DWABUSI	DWAAERO	DWABANK	DWAEUTI	DWALEIS	DWAFOOD	DWAWAST	DWAGUTI	SPXEWI	DWACOMP	DWAINET
1	DWABUIL	38	39	77		BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX
2	DWARETA	36	31	67		BO	BX	BX	BX	BO	BX	BX	BX	BO	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX
3	DWAREST	36	20	56		BX	BO	BX	BO	BO	BX	BO	BX	BO	BX	BX	BO	BX	BO	BX	BX	BO	BX	BX	BX
4	DWAPREC	33	40	73		BX	BX	BX	BX	BX	BX	SX	BX	SX	BX	BX	SX	BX	BX	BX	BX	BX	BX	BX	BX
5	DWABIOM	33	35	68		BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	SX	BX	BX	BX	BX
6	DWAPROT	33	19	52		BO	BX	BX	BO	BO	BO	BO	BX	BO	BX	BX	BX	BX	BX	BO	BO	BO	BX	BX	BX
7	DWAREAL	32	13	45		BO	BO	BO	BO	SO	BO	BO	BX	BO	BX	BX	BO	BX	BX	BX	BX	BX	BX	BO	BO
8	DWADRUG	31	16	47		BO	BO	BO	BO	SO	BO	BO	BX	BO	BX	BX	BO	BX	BO	BX	BX	BX	BX	BX	BX
9	DWAFORE	29	34	63		BX	BX	BX	BX	BX	BX	BX	BX	BO	BX	BX	BO	BX	BX	BX	SX	BX	BX	BX	BX
10	DWATEXT	29	25	54		BO	BX	BX	BO	BO	BX	BX	BX	BO	BX	BX	BO	BX	BX	BX	BX	BX	BX	BX	BO
11	DWAHOUS	28	25	53		BX	BX	BX	BO	BX	BX	BX	BX	BX	BX	BX	BO	BX	BO	BX	BX	BX	BO	BX	BO
12	DWASOFT	28	19	47		BO	BX	BX	BX	BX	BX	BX	BX	BO	BX	BX	BO	BX	BO	BO	BX	BX	BX	BX	SO
13	DWAGAME	26	7	33		BO	BO	BX	BO	BX	BX	BO	BX	BO	BO	BO	BO	BO	BO	BO	BO	BX	BO	BO	BO
14	DWACHEM	25	21	46		BX	BX	BX	BX	BO	BX	BO	BX	BO	BX	BX	BO	BX	SO	BX	BX	BO	BX	BX	SX
15	DWAAUTO	25	12	37		BX	BX	BX	BO	BO	BX	BO	BO	BO	BO	BX	BO	BX	BO	BO	BO	SO	BO	BX	BO
16	DWAMACH	24	22	46		BX	BX	BX	BX	BO	BX	BO	BX	BX	BX	BX	BO	BX	BO	SX	SX	BX	BX	SX	BO
17	DWAMEDI	23	34	57		BX	BX	BX	BX	BO	BX	BX	BX	SX	BX	BX	BX	BX	SX	SX	BX	BX	BX	SX	BX
18	DWASAVI	22	32	54		BX	BX	BX	BX	BO	BX	BX	BX	BO	BX	BX	BX	BX	SX	SX	SX	SO	SX	BX	BX
19	DWAHEAL	22	19	41		BX	BO	BX	BO	BO	BX	BO	BX	BO	BX	BX	BX	BX	BO	SX	BX	BX	SO	BO	SX
20	DWAINSU	22	15	37		BX	BO	BX	BO	BX	BX	BO	BX	BO	BX	BX	BO	SX	BO	BO	SX	BX	BO	SX	SO
21	DWAFINA	21	29	50		BX	BX	BX	BX	BO	BX	BX	BX	BO	BX	BX	BO	BX	BO	BX	BX	SX	BO	SX	BX
22	DWAINET	21	22	43		BX	BX	BX	BX	BO	BX	BX	BX	BO	BX	SX	BO	SX	BO	BX	BX	BO	BX	BX	
23	DWACOMP	20	10	30		BO	BX	BX	BO	BO	SX	BO	BX	SO	BX	BO	BO	BX	BO	BO	BO	BX	BO		SO
24	SPXEWI	17	19	36		BX	BX	BX	BX	BO	BX	BX	BX	BO	SX	SX	BO	BX	BO	BX	BX	BO		SX	SO
25	DWAGUTI	17	14	31		BO	BO	BO	BO	BO	BO	BO	BX	BO	BX	BX	BO	BX	BO	SX	SX		SX	SO	SX
26	DWAWAST	17	7	24		BO	BO	BO	BO	SO	BO	BO	BX	BO	SX	BX	SO	BO	BO	BX		BO	SO	SX	SX
27	DWAFOOD	15	13	28		BO	BX	SO	BX	SO	BX	BO	BX	BO	BX	BX	SO	BX	SO		SO	BO	SO	SX	SO
28	DWALEIS	14	28	42		BX	BX	BX	BX	BX	SX	BO	BX	SO	BX	BX	BO	SX		BX	SX	SX	SX	SX	SX
29	DWAEUTI	13	1	14		BO	BO	BO	BO	SO	BO	BO	BO	BO	BO	BO	SO		BO	SO	SX	SO	SO	SO	BO
30	DWABANK	12	30	42		BX	BX	BX	SX	BX	BX	SO	BX	BO	SX	SX		BX	SX	BX	BX	SX	SX	SX	SX
31	DWAAERO	12	9	21		BO	BX	BX	BX	BO	BX	BO	SX	BO	SX		BO	SX	BO	SO	SO	SO	BO	SX	BO
32	DWABUSI	11	8	19		BX	BX	BX	BX	BO	BO	SO	SX	BO		BO	BO	SX	SO	SO	BO	SO	BO	SO	SO
33	DWAOILS	10	33	43		BX	BX	SX	BX	BX	BX	BO	SX		SX	SX	SX	SX	BX	SX	SX	SX	SX	BX	SX
34	DWATRAN	10	2	12		BO	BO	BO	BO	BO	BX	BO		BO	BO	BO	SO	SX	SO	SO	SO	SO	SO	SO	SO
35	DWAOIL	9	27	36		BX	BX	BX	BX	BX	BX		SX	SX	BX	SX	BX	SX	SX	SX	SX	SX	SX	SX	SO
36	DWASEMI	7	6	13		BO	BO	BO	BO	BO		SO	SO	SO	SX	SO	SO	SX	BO	SO	SX	SX	SO	BO	SX
37	DWASTEE	6	25	31		BO	SO	SO	SX		SX	SO	SX	SO	SX	SX	SO	BX	SO	BX	BX	SX	SX	SX	SX
38	DWATELE	5	19	24		BX	BX	BX		BO	SX	SO	SX	SO	SO	SO	BO	SX	SO	SO	SX	SX	SO	SX	SO
39	DWAWALL	4	10	14		SX	SO		SO	BX	SX	SO	BX	BO	SO	SO	SO	SX	SO	BX	SX	SX	SO	SO	SO
40	DWAELEC	3	14	17		BX		BX	SO	BX	SX	SO	SX	SO	SO	SO	SO	SX	SO	SO	SX	SX	SO	SO	SO
41	DWAMETA	1	14	15			SO	BO	SO	SX	SX	SO	SX	SO	SO	SO	SO	SX	SO	SX	SX	SX	SO	SX	SO

FIGURE 5.14 DWA Relative Strength Chart Matrix

(security) drops out of the top half of the matrix. At Dorsey, Wright and Associates we have taken another step forward in our sector rotation research by developing a model using our DWA sector indexes (and specifically using the RS matrix that we just discussed and showed in Figure 5.14). We embarked on this task for numerous reasons:

- To provide an unbiased representation of a tactically managed sector rotation strategy.
- To demonstrate the robustness of a sector rotation strategy based on relative strength whose universe is not composed of ETFs.
- To offer a way to display the long-term benefits of an RS-based sector rotation strategy using underlying indexes that have been published since

1997. This can help with regulatory and compliance issues related to back-tested data on ETFs.

- For prospecting purposes. This DWA sector index model allows you to explain the "process" of using the RS matrix for portfolio construction.

With that said, let's take a look at the study we conducted, and resulting DWA Sector Seven Index Model portfolio. Realize that this model portfolio cannot be bought in a strict sense, given that our DWA sector indexes are not publicly traded. Instead, this model will be best used to explain the long-term benefits of implementing a sector rotation based strategy, even if it's only for a portion of your total portfolio. But, obviously, the information could be used to offer a "solution" in that you could take the recommended sector holdings and then populate your portfolio with either stocks or ETFs associated with the recommended sectors from the Model.

DWA Sector Seven Index Model Universe and Portfolio Rules

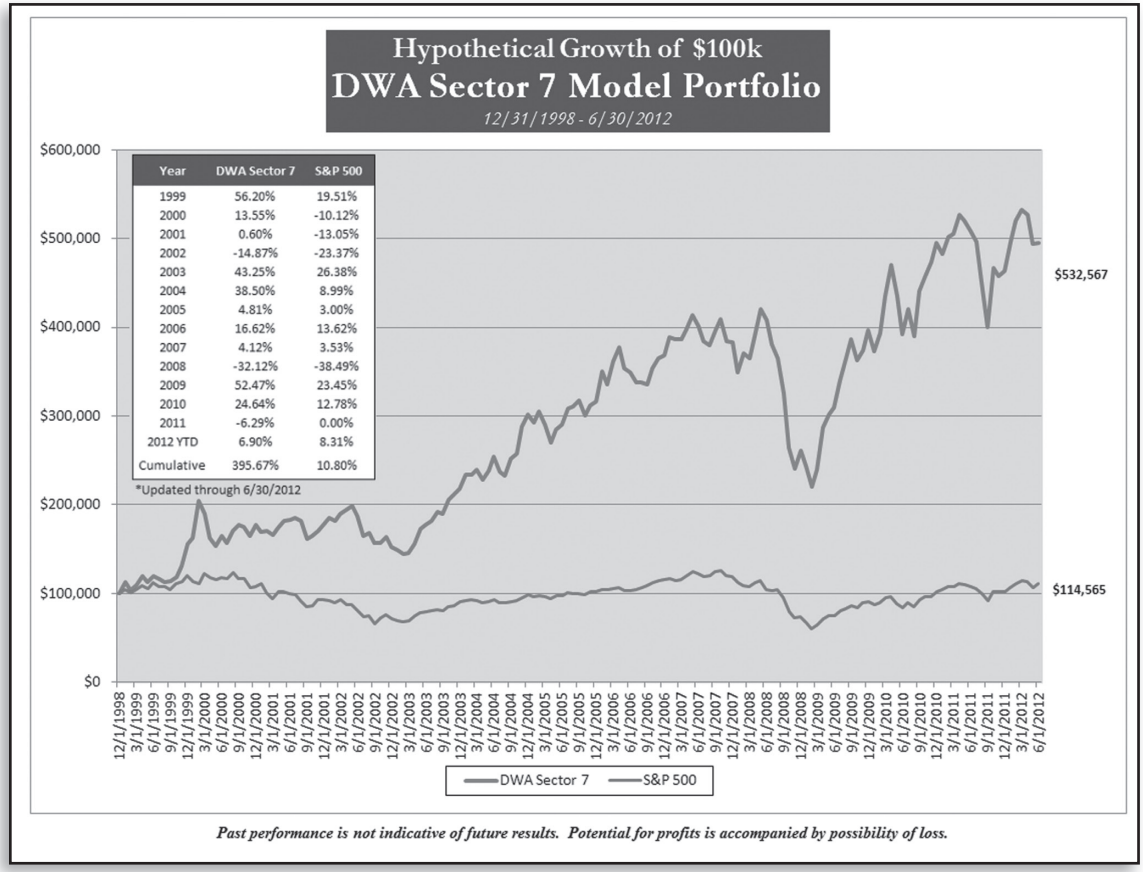
The universe for the DWA Sector Seven Index Model Portfolio is our DWA sector indexes, of which there are 40. We started constructing these indexes back in the mid-1990s, and have published data for each sector going back to 1997. Each DWA sector index is equal weighted among its members and is rebalanced on a daily basis. The number of members for each index varies between roughly 19 and 29 members, depending on the sector. For example, the DWA Bank Index (DWABANK) has 28 members, while the DWA Textiles & Apparel Index (DWATEXT) has 20 members. Our 40 DWA sector indexes are not reconstituted on a regular basis, such as quarterly or annually, like many indexes and ETFs, but instead are changed on an as-needed basis due to takeovers, bankruptcies, or a material drop in price (typically below $5). When looking at the entire membership of our sector indexes, in aggregate, the market cap breakdown is pretty well distributed across large, mid, and small cap. Realize, though, that the market cap dispersion will vary depending on the specific sector. For example, the DWA Oil Index (DWAOIL) has a definitive slant toward large cap with its membership, while DWATEXT is clearly overweighted to small cap. As a general rule, we have attempted to provide, for each sector index, a good representation from each group, by and large populating the index with those names that are most well known and synonymous with the given sector.

DWA Sector Seven Index Portfolio Rules

- DWA sector indexes are the universe used.
- Remains 100 percent invested at all times.
- DWA sector indexes are compared to each other using RS, and specifically in an RS matrix structure composed of all 40 DWA sector indexes.
- The top seven RS ranking sector indexes are bought and are sold only when a given sector falls sufficiently out of favor on an RS basis versus the other potential sectors for the portfolio.
- A new sector is added only when another sector is removed (replacement method).
- When an addition/deletion is made, the portfolio is rebalanced so that each position is equally weighted.

DWA Sector Seven Index Model Historical Testing Information

One of the greatest advantages of using the DWA Sector Seven Index Model as a representation of an RS-driven sector rotation strategy is the fact that its performance is based purely on "live" data. As we stated earlier, we have maintained each of the 40 DWA sector indexes going back to 1997, so there are no back-tested returns associated with the Model over that period of time. With that said, let's take a look at how implementing this type of strategy during the past 13 years would have rewarded investors. The equity curve, Figure 5.15, shows the growth of a $100,000 portfolio invested strictly in the DWA Sector Seven Index Model portfolio since December 31, 1997, compared to buying and holding the SPX. As you can see, that $100,000 would now be over half a million, whereas the same $100,000 that bought and held the S&P 500 Index has gained only a mere $14,565 (all data and returns are through June 30, 2012). Of course, it was not always smooth sailing in the Sector Model, which can be best demonstrated by a year like 2008. You'll recall that 2008 left us nowhere to hide and take cover in the equity markets, and during that year the Sector Model took a hit of –32.12 percent. The important thing to highlight overall is that implementing a tactical sector rotation strategy that forces you to remain objective in your investing can grossly improve performance in the long term.



Year	DWA Sector 7	S&P 500
1999	56.20%	19.51%
2000	13.55%	-10.12%
2001	0.60%	-13.05%
2002	-14.87%	-23.37%
2003	43.25%	26.38%
2004	38.50%	8.99%
2005	4.81%	3.00%
2006	16.62%	13.62%
2007	4.12%	3.53%
2008	-32.12%	-38.49%
2009	52.47%	23.45%
2010	24.64%	12.78%
2011	-6.29%	0.00%
2012 YTD	6.90%	8.31%
Cumulative	395.67%	10.80%

*Updated through 6/30/2012

FIGURE 5.15 DWA Sector Seven Model Portfolio Performance Graph

Although historical performance is not indicative of future results, reviewing previous returns does provide us with valuable insight into how sector rotation strategies have navigated past market environments. With that said, the DWA Sector Seven Model does not always outperform all other areas of the market (broad sectors), specifically during times of rotation in leadership. For instance, in 2007 we found that the lag in the portfolio was attributed to its rotation out of Financials. Both the Real Estate sector and the Wall Street sector went into the model portfolio back in mid- to late 2006, and it wasn't until mid-2007 that we were able to sell those sectors and rotate into stronger areas of the market. It is important to understand that there are a few market environments in which relative strength strategies will lag. One pertains to changes in leadership, as just mentioned. By nature, RS will not get you in at the exact bottom, nor will it get you out at the exact top. It will, however, allow you to catch the majority of the long-term move. The year 2007, in which it took us a while to rotate out of both the Wall Street sector and the Real Estate sector, provides a case in point of this type of lag. The other time we will see relative strength strategies struggle is during narrow or choppy markets, where leadership is not well defined. Historically, the average dispersion between the best- and worst-performing sectors over the past 13 years has been about 105 percent, leaving us plenty of opportunity to identify outliers both to the upside and the downside through relative strength. It is during markets in which this differential is below average that we may see underperformance (compared to the benchmark). Of course, the most recent example of this type of market was 2011. Because RS captures long-term trends, it will underperform during trendless or choppy markets, which was the case throughout most of 2011. For instance in 2011, the dispersion between the best and worst sectors of the U.S. market were only half of their historical average, meaning there was very narrow divergence from sector to sector. In analyzing these RS laggard periods for the DWA Sector Seven Model on a quarterly basis, we find that going back to the beginning of 1998, the Model has outperformed the S&P 500 roughly 72 percent of the time. Additionally, when it outperforms, it does so by about 6 percent.

DWA Sector Seven Index Model Portfolio Stats

Now let's review the trade history of the DWA Sector Seven Model to see behind the blind performance numbers and into the mechanics of the Model. In Figure 5.16 we have outlined some of the more notable information we came across when conducting our trade analysis including turnover, winning trades

DWA Sector 7 Index Model Trade Statistics	
# Winning Trades	76
Average % Gain for Winners	32.58%
Average Time Winning Trades Held	350.11
Median # of Days Winning Trade Held	251.00
% Winning Trades Held More Than Year	41%
# Losing Trades	57
Average % Loss for Losers	-14.57%
Average Time Losing Trades Held	138.61
Median # of Days Losing Trade Held	109.00
% Losing Trades Held Less Than Year	92.98%
# Total Trades	133
Average % Gain/Loss for All	12.37%
% of All Trades held more than 1 year	26.32%
Average # of Days All Positions Held	259.47
Median # of Days All Positions Held	155.00

Portfolio Trades per Year	
Year	# of Trades
1999	13
2000	14
2001	15
2002	11
2003	8
2004	5
2005	5
2006	8
2007	5
2008	13
2009	16
2010	4
2011	6
2012 YTD	3
Average Trades	9.0

*Updated through 6/30/2012

FIGURE 5.16 DWA Sector Seven Model Portfolio Statistics

compared to losing trades, and tax efficiency. Going back to the beginning of 1999, we have made a total of 133 trades (including trades into the seven opening positions), with each of those trades averaging a return of 12.37 percent. Specifically, 76 of those trades worked out to our advantage, posting absolute positive returns. The other 57 were considered losing trades. We often say that in this business it's okay to be wrong, but it is not okay to *stay* wrong. By following the rules-based approach of this model portfolio, we are able to correct ourselves from "wrong" trades by holding them on a short-term basis. In fact, nearly 93 percent of the losing trades were short-term losses, with holding periods less than one year. On the other side of the coin, relative strength also forces us to stay right and realize gains on a long-term basis allowing for tax efficiency. A solid 41 percent of the winning trades were held at least 365 days. In terms of turnover, the model portfolio has seen anywhere from 4 to 16 trades in past years, but it averages about 9 trades per year.

In all, we believe this extensive study proves the validity of using the RS matrix concept for investment decisions. Of course, such a strategy is not without its limitations or "Achilles heel," but the benefits, as shown in the data, tend to far outweigh these limits. In the end, a systematic, tactical, rules-based approach to sector rotation, using RS is a robust method for equity selection.

Stock-to-Stock Matrix

The DWA RS Chart Matrix product, as previously outlined, evaluates RS between multiple securities (sectors), rather than just against the market or one other index. We now want to take it a step further and enlighten you to how this same concept can be applied to a group of stocks. The goal here is the same—to identify from a group of stocks those that are the RS leaders.

For this style of matrix, the basis or starting point comes from creating an RS chart along the lines of the Pepsi (PEP) versus Coca-Cola (KO) RS chart, comparing the performance of one stock to another. Once again, the underlying calculation is the same in that we divide the closing price of one stock by another stock. The matrix in this case is sector specific, and is composed of 20 to 25 representative stocks from a given sector. The member stocks are optionable and tend to be the larger cap or more well-known names from the group. For example, the Food, Beverage & Soap sector matrix would include such stocks as PEP, KO, Altria (MO), Archer Daniels Midland (ADM), Colgate-Palmolive (CL), Hershey's (HSY), Procter & Gamble (PG), and so forth. To create the matrix, we literally create an RS chart of every stock in the list against every other stock. This allows us to identify the strongest stocks relative to the other 20 to 25 names. For example, ADM would have approximately 20 RS charts, one against PEP, KO, MO, CL, and so on. In addition to the stocks, we also include an RS chart versus the DWA Food Sector Index (DWAFOOD). All told, we have a stock matrix for every one of our 40 DWA sectors. This allows us to know at any given point, on a relative basis, what are the best-performing stocks in the Semiconductor group or the Biotech sector, for example.

The layout of each matrix is the same as that outlined with the DWA RS Chart Matrix; the RS signal of each chart is represented by a "B" for buy signal, an "S" for sell signal, with the "X" and "O" representing the recent column reading of each RS chart. Likewise, a similar ranking system is used to tally all of this RS data. Again, it is based on the total number of RS charts that are on a buy signal for a given stock, and the one that has the most is ranked as number 1. For the stock with the lowest number of buy signals, it is ranked last and appears at the bottom of the matrix. In the event of a tie, it is again broken based on the ones that have the most RS charts in a column of X's.

When using such a matrix for individual stock purchases, you undoubtedly want to focus your buying on those stocks that are at the top of the matrix as they are the ones that are outperforming the other member stocks. In Figure 5.17, the Food, Beverage & Soap stock matrix is shown. Clearly,

Rank	Ticker	Buys	Xs	Tot Combo	Tech Attrib/ Score	ADM	CPB	TAP	HSH	K	PG	SYY	CAG	LO	GIS	UN	BG	PEP	HNZ	DWAFOOD	KFT	A
1	DEO	24	24	48	5.00 ↑	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX	BX
2	HSY	23	19	42	5.00 ↑	BX	BX	BO	BO	BX	BO	BX	BO	BX	BX	BO	BO	BX	BX	BX	BX	BX
3	PM	23	9	32	5.00 ↑	BO	BO	BO	BO	BO	BO	BO	BO	BX	BX	BO	BO	BX	BX	BX	BO	BX
4	MO	21	6 ↑	27	4.00 ↑	BO	BO	BO	BO	BO	BO	BO	BO	BX	BX	BO	BO	BO	BX	BO	BO	B
5	BTI	20	8	28	5.00 ↑	BO	BO	BO	BO	BO	BO	BO	BO	BX	BX	BO	BX	BX	BX	BO	BO	BX
6	DF	19	6 ↑	25	5.00 ↑	BO	BO	BO	BO	BO	BO	BO	BO	BX	BO	BO	BO	SX	BO	BO	BO	B
7	KO	18	5	23	3.00 ↑	BO	BO	BO	BO	BO	BO	BO	BO	BX	BX	BO	BO	BO	BX	BO	BO	SX
8	RAI	17	7 ↑	24	5.00 ↑	BO	BO	BO	BO	BO	BO	BO	BO	SX	BO	BO	SO	BX	BX	BO	BO	SX
9	CL	16	18	34	3.00 ↑	BX	BX	BO	BX	BX	BO	BX	BO	BX	BX	BX	BO	BX	BX	BX	SX	SX
10	ABV	16	4	20	4.00 ↓	BO	BO	BO	BX	SO	BO	BO	SO	BX	BO	BO	SO	BO	BO	BO	BO	
11	KFT	15	16 ↑	31	3.00 ↑	BX	BX	BO	BO	BX	BO	BX	BO	SX	BX	BX	BO	BO	BX	BX		S
12	DWAFOOD	12	15	27	N/A	BX	BX	BO	BX	BX	BO	BX	BX	BX	SX	BO	BO	BO	SX		SO	SX
13	HNZ	11	12	23	4.00 ↑	BX	BX	BO	BX	BX	BX	BX	SX	BX	SX	BX	BO	BO		SO	SO	SX
14	PEP	11	12	23	1.00 ↓	BX	BX	BO	BO	BO	BO	BX	BO	BX	SX	SO	BO		SX	SX	SX	S
15	BG	10	17 ↑	27	1.00 ↓	BX	BO	BO	BX	BO	BO	SX	BO	SX	BX	BO		SX	SX	SX	SX	SX
16	UN	9	21	30	2.00 ↑	BX	BX	BX	BX	BX	BX	SX	SX	BX	BX		SX	BX	SO	SX	SO	SX
17	GIS	9	9	18	3.00 ↓	BX	BO	BO	BX	BX	SO	SO	BX	SX		SO	SO	BO	BO	BO	SO	SX
18	LO	9	0	9	2.00 ↓	BO	SO	BO	SO	BO	BO	SO	BO		BO	SO	BO	SO	SO	SO	BO	S
19	CAG	8	17 ↑	25	1.00 ↓	BX	BO	SO	SX	BX	BO	BO		SX	SX	BO	SX	SX	BO	SO	SX	B
20	SYY	8	14	22	1.00 ↓	BX	BX	BO	BX	BX	SO		SX	BX	SX	BO	BO	SO	SO	SO	SO	SX
21	PG	6	21	27	2.00 ↓	BX	BO	BX	BX	BX		BX	SX	SX	SX	SO	SX	SX	SO	SX	SX	SX
22	K	4	12	16	1.00 ↓	BX	BO	SO	BX		SO	SO	SO	SX	SO	SO	SX	SX	SO	SO	SO	B
23	HSH	4	10	14	3.00 ↓	BO	SO	BO		SO	SO	SO	BO	BX	SO	SO	SO	SX	SO	SO	SX	S
24	TAP	3	21	24	1.00 ↑	BX	SO		SX	BX	SO	SX	BX	SX	SX	SO	SX	SX	SX	SX	SX	SX
25	CPB	3	15	18	1.00 ↓	SX		BX	BX	SX	SO	SO	SX	BX	SX	SO	SX	SO	SO	SO	SO	SX
26	ADM	1	9	10	0.00 ↓		BO	SO	SX	SO	SO	SO	SO	SX	SO	SO	SO	SO	SO	SO	SO	SX

FIGURE 5.17 Stock-to-Stock Matrix: Food & Beverage RS Matrix

Diageo (DEO) should catch your attention because it resides in the top spot, followed by Hershey Company (HSY), Philip Morris (PM), and Altria Group (MO). Those to avoid or consider as shorts would be names such as Archer Daniel Midland (ADM) and Campbell Soup Company (CPB), as they sit in the cellar on the FOOD matrix. Taking it a step further, by using this type of matrix in conjunction with the positive technical attributes reading, you can easily stack the odds in your favor with respect to your individual equity positions. Moreover, you could take the recommended sectors (to own) from the Sector Seven Model, and then consult each of the seven sectors' specific RS matrix—choosing those stocks that reside at the top of the matrix and that also have high technical attribute readings. This is one clear-cut way to construct a strong RS portfolio of individual equities in a very systematic fashion.

In conclusion, this matrix concept can be applied to any number of universes. For instance, a matrix can be built to compare all sector ETFs to each other, or one that conducts an arm-wrestling match between all the different commodities. The results will be the same—the matrix will identify those securities that are outperforming; it will tell you who has won the round-robin arm-wrestling tournament.

Summary

Throughout this chapter, we have tried to demonstrate to you the robustness, and more notably, the adaptability of RS; and how this simplistic tool enables you to capture the large winning trades, while helping you to avoid the big losers. You have hopefully learned that RS is not only useful for individual stock evaluation, but that it can be applied across a broad range of financial products. Moreover, the calculation is consistent across the board, as is the interpretation of the RS chart, with the overall goal being the same regardless of what you are measuring—to determine outperformance or underperformance.

The adaptability of RS is amazing in that it allows you to analyze so many different pieces of the investment puzzle. As discussed, RS is a must with respect to sector rotation, as this is where the majority of risk resides in any given stock. Not only that, a broad appreciation of where to tactically maneuver with respect to your strategic asset allocation pie can be accomplished with just a few RS charts. Basic but important questions on asset class, market cap, and style can be easily answered with a glance at an RS chart. And new horizons can be traveled to, with greater confidence, by consulting RS charts on different regions and countries. Without a doubt, the possibilities are limitless.

In the end, these different RS applications provide great insights into where best to allocate your investment dollars. Put together, they create a dramatic and discernible picture and, from that, an understanding of what is happening in the financial world. All told, the final result is the same—you focus your buying on those securities, sectors, indexes, or funds exemplifying the strongest RS, and sell or avoid those vehicles that display the weakest RS. Remember, as Yogi Berra used to say, "You can observe a lot just by watching."

CHAPTER 6

Primary Market Indicators for Gauging Risk

This chapter on the New York Stock Exchange (NYSE) Bullish Percent covers a critical area of investment strategy (see Figures 6.1a, 6.1b, and 6.1c). It is critical that you grasp this concept thoroughly. This index is our main coach and dictates our general market posture. Since my first book was published, our experience with this concept has strengthened my conviction that this is the absolute best market indicator for perspective on the markets, not in and out trading day to day. Now that the fourth edition of this book is coming out, we have expanded our thought process on asset allocation and playing offense or defense with the markets. Don't get me wrong—this index is very important to me and guides my thoughts on whether to be offensive or defensive with respect to my market posture. However, relative strength (RS) has taken over for guiding us in what asset classes we need to be invested in as well as what sectors, stocks, funds, or commodities should be used to populate this asset mix. How enthusiastic I am about investing the maximum into a portfolio will be guided by this index. You see, they both play important roles in the investment process. This index, in combination with the Nasdaq Bullish Percent, has guided our decisions through the murky markets of 1999 and 2000 with flying colors, the bear market from 2000 to 2002, powerful moves up from bottoms in 2003 and 2009, a sideways market from 2004 to 2005, a global meltdown in

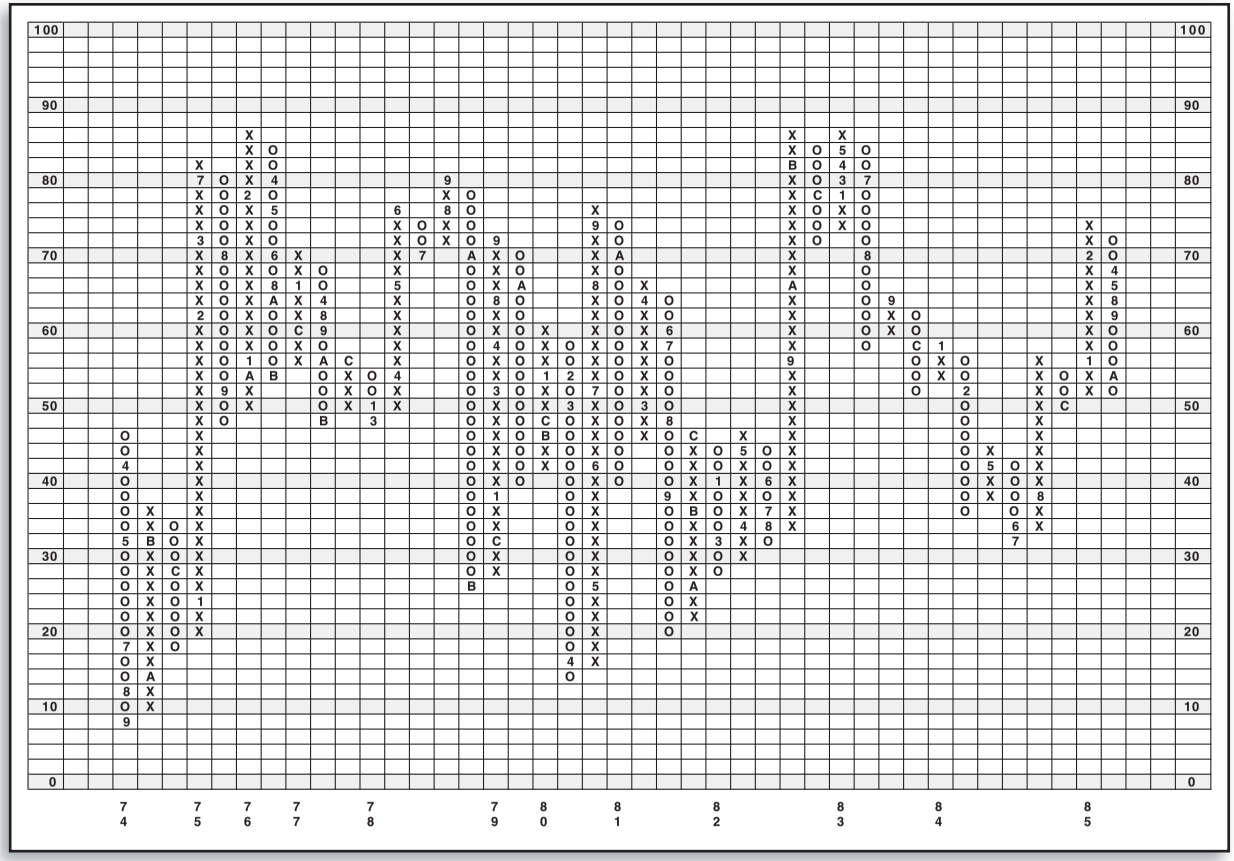


FIGURE 6.1a NYSE Bullish Percent, 1974–1985

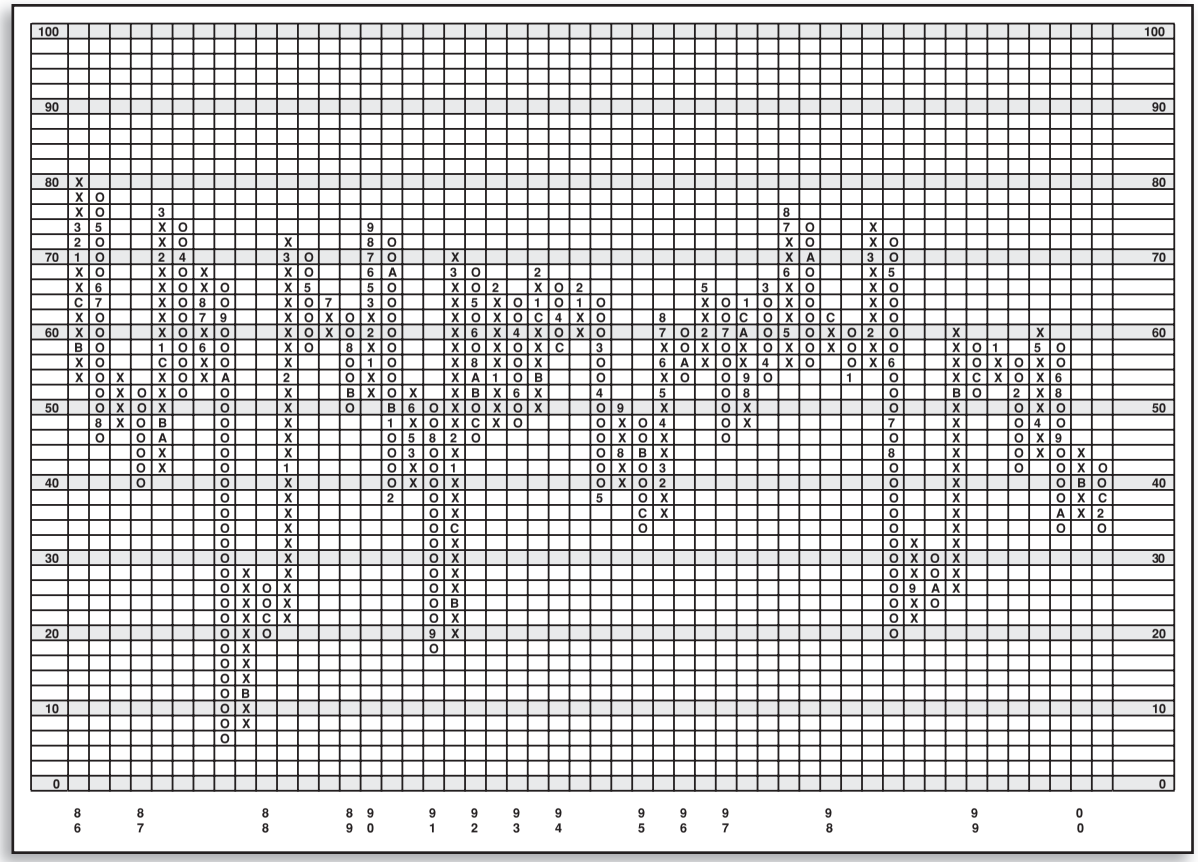


FIGURE 6.1b NYSE Bullish Percent, 1986–2000

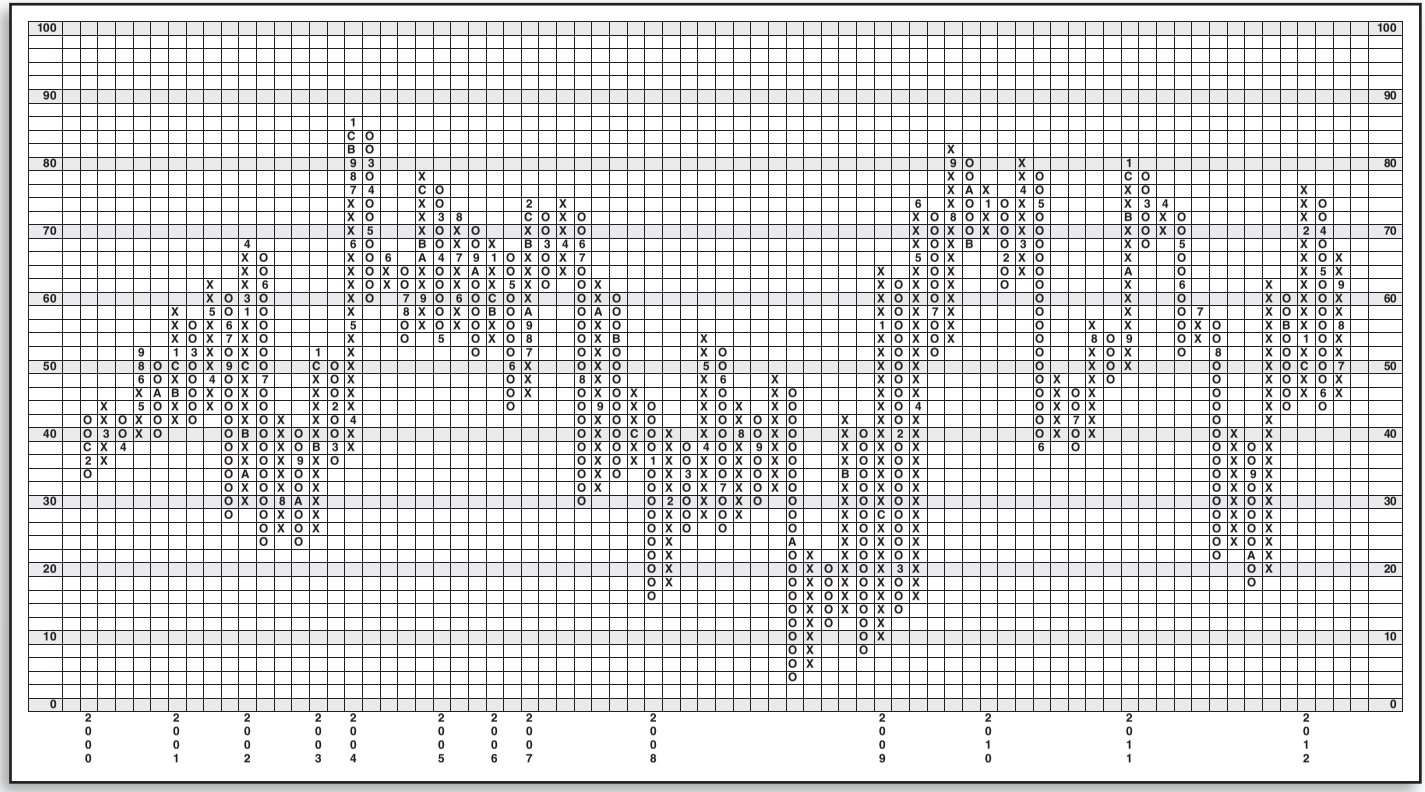


FIGURE 6.1c NYSE Bullish Percent, 2000–2012

2008, and a market driven by international crises from 2010 to the writing of this edition in 2013. It continues to amaze me how effective this index is at alerting us to which team, offense or defense, is on the field.

It wasn't until January 1987 that I began to fully understand what the Bullish Percent Index was all about. That was the month my partner, Watson Wright, and I started Dorsey, Wright & Associates (DWA). Before that, I was director of options strategy at a large regional brokerage firm, Wheat First Securities. Although my department was self-contained, in that we did our own research and never piggybacked off the firm's recommendations, we did use another outside service for our intermediate-term market outlook in addition to the Bullish Percent Index. I am an adamant believer in the KISS principle ("keep it simple, stupid"), from investing to running a company. When we started our own company, I wanted to stick with the basics, and this continued to draw me back to the Bullish Percent concept I had used previously. What we found is that when the market in general had an upward bias, the call recommendations generally worked. When the general market was losing ground, the call recommendations did not work as well, but the put recommendations worked really well. In other words, we found that the first step in our game plan for investing was to determine the general direction of the market. Was the market supporting higher prices or not? It's kind of like the tide going in and out in a marina. When the tide goes in, all boats are lifted. Conversely, when the tide goes out, all boats decline. Miss this concept and you are going to be dead in the water.

This concept has been numerically quantified by several studies, including one by the University of Chicago and another described by Benjamin F. King in his book, *The Latent Statistical Structure of Securities Price Changes* (Chicago: University of Chicago Press, 1964). What these studies quantified is that 75 percent to 80 percent of the risk in any individual stock is in the market and the sector. Only 20 percent of the risk in any individual stock is related directly to that issue. Therefore, as we began building our business, we put tremendous credence in the Bullish Percent concept to tell us whether the tide was rising or falling in the market, and this guided our recommended strategies in the market. It is now 26 years later, and I am even more convinced this is the right concept to guide our broad market posture. I have used this Bullish Percent concept now through every kind of market you can imagine during these past 26 years. We have successfully negotiated the crash and subsequent recovery of 1987, the recession and war in the Middle East during 1990–1991, the stealth bear market of 1994 and subsequent phenomenal bull market for the next several years, the bear

market/Asian crisis of 1998, the bull market in indexes and bear market in stocks from 1998 to 2000, and the over-the-counter (OTC) meltdown of 2000. In the twenty-first century this indicator worked just as well, aptly guiding us during major market meltdowns of 2000–2002 and 2008, and the subsequently powerful bottoms put in during 2003 and 2009, as well as the sideways markets of 2004–2005, and volatility prone markets of 2010 and 2012. As the different types of markets have come and gone, I am even more impressed with how the Bullish Percent concept saw us through each market in fine form. Some markets are more volatile than others and require more vigilance, but they don't differ much from a football game. Some games are marked by many turnovers, while others are marked by long periods of possession of the ball. Still other games are defined by how a certain team played defense. Often, success in investing is more about what you didn't own than what you owned. Every game is different, but the process and rules of playing the game never change. It is imperative that you learn this concept well and keep it in the forefront of all your market decisions. The Point and Figure method of analysis is not a science; it is, however, an art. The more you study the history of the Bullish Percent concept and use it, the better you will be at interpreting it and thus better at the investment process. Remember, you are an integral part of this whole program; nothing works without your craftsmanship.

Do You Have an Operating System?

During the 1980s, the market pretty much went up. It was a good time to be alive. Everyone was doing well, employment was high, the country was not divided, and things were just good. This decade made the reputations of many investment advisers and money managers, who then slipped back into obscurity in the 1990s. The decade of the 1990s ushered in a new breed of money manager. Many money managers in the 1990s had much in common with an eight-year-old snow skier—no fear. I remember financial television stations sporting fundamental analysts who had found new ways to evaluate companies that had no earnings, no hope of any earnings, and no real reason to even be listed on any exchange. This was one of the most amazing times I have seen in the stock market. If you asked an investor why they bought particular stocks, you would likely get the following response: "Because it's going up." Gravity eventually upsets a good thing, optimism quickly turns to pessimism, and those who were once considered heroes

settle back to being mere mortals as their clients lose their shirts. I've seen this time and again during my career.

We primarily focused on the option stock universe in the 1980s, and to a lesser degree on the general market of stocks that did not have options attached to them. Stocks generally rose during this period, so the focus was on catching the next rising star. The 1980s were wild indeed. Things were popping, and the listed derivatives market was only about seven years old, having debuted in April 1973. By the time the 1980s rolled around, options derivatives were the fastest game in town. If I were asked to define that period with one word, it would be overleverage. It seemed everyone had a stake in the game. By 1987, the game had gotten easy and everyone, it seemed, had become comfortable with the state of the market. Rising prices translated into easy money in options. Until October 1987, that is. Once again, gravity exerted its influence, and in one day the air came out of the balloon. Today, with the Dow Jones at about 13,275, a similar drop to that of October 1987 would be the equivalent of falling about 3,000 points in a single day. Can you imagine the field day the media would have with that magnitude of a drop? I can tell you this: they would be saying it was the end of the world. And we've already been there, done that. One of the strategies that created the October 1987 22.6 percent decline in one day was the misuse of put options, which, in turn, had a dampening effect on the options market. Put options can be viewed as insurance products. Buyers of puts are typically seeking insurance to hedge some market risk they are unable or unwilling to accept. The seller of puts, however, is contracting to provide the insurance the buyer is seeking. A put seller stands ready to purchase stock at a certain price for the life of the contract, no matter how far below that price the stock declines. This is similar to an insurance company's insuring your car for the stipulated duration of the contract. The insurance company will make you whole if you have an accident. If cars never had any accidents, the insurance business would be the greatest business of all—good premiums and no risk. Because stocks rarely had accidents during the early 1980s, investors decided to enter the underwriting business. You know what happens when everyone thinks some investment is too good to be true—it generally is. Well, in October 1987, every stock on the stock exchange had an accident on the same day. The casualty companies of the stock market (put sellers) all went bankrupt. I am referring to the investors who sold those puts that, up until October, usually expired worthless. This expiration month, they didn't. From that day on, the options market changed.

Did that rendition of what happened in 1987 ring a bell? It's exactly what happened in the real estate collapse in 2008. Remember the fancy term *credit default swaps?* They are simply put options. These put options were sold by underwriters like AIG Corporation. They promised to make you whole if your subprime mortgage package of garbage blew up. There is nothing new here. One party buys a risky asset and finds it necessary to buy insurance for indemnification. The other party is in the business of selling this insurance, the "underwriter," like AIG. Merrill Lynch bought the subprime mortgages and bought insurance along with them. They significantly declined in price when it was found out they were nowhere near AAA rated. They exercised the puts AIG sold them but AIG didn't have enough money to back the insurance. Hey real estate doesn't go down, they don't make any more of it, right? As the late Paul Harvey used to say, "Now you know the rest of the story." Well, it was contagious; it spread to Europe, so here we sit in 2013 still affected by the happenings of 2008.

This isn't anything new. It's been going on since the tulip craze in the 1600s. It happened with Internet stocks in the late 1990s and early 2000. And I am sure it will happen in the future. You would think investors and regulators would learn from their mistakes or at least learn from history, but the conventional wisdom always seems to suggest that "this time is different." Most investors make the same mistakes year in and year out. Their biggest mistake is operating in the markets without a logical, organized method of analysis. I see it day in and day out. So much information is available today that investors are more confused than ever about how to manage their money. Most investors and brokers don't operate in the markets with a defining process, an operating system if you will. However, a select group of brokers have taken it upon themselves to see that they are well educated in this Point and Figure methodology. They have attended our Point and Figure Institute in Richmond, Virginia. These craftsmen brokers have a solid game plan for their customer that incorporates the strategies of wealth preservation and wealth accumulation based on the concepts discussed in this book.

If I could impress on you one fact, it would be that at least 75 percent of the risk in any stock is associated with the market and sector. If the overall market is not supporting higher prices, very few stocks you own, if any, will do well. In the past, I spoke at the Yale Club's annual Wall Street Night with Merrill Lynch's director of Investment Strategy, PaineWebber's director of Investment Strategy, Jim Rogers, Abbey Cohen, and some of Wall Street's top economists, in all, some of Wall Street's brightest people. The second year I was invited to speak I brought a chart I always use when I explain the

Bullish Percent concept. This chart is a schematic of a football play we often see on TV during football games. This chart is my way of demonstrating how we view the market as a football game where the play shifts from offense to defense throughout the game. Once the other panelists had finished discussing the market's outlook, it was my turn. I put up a football schematic like the one John Madden used to write on the TV screen with his grease pencil showing what just happened on the last play. This chart (Figure 6.2) drove home the point I was trying to make that evening: the first thing an investor must know before investing any money is whether the offensive team or defensive team is on the field.

In a football game, two forces operate on the field at any one time, offense and defense. The same forces act in the marketplace. There are times when the market is supporting higher prices and times when the market is not supporting higher prices. When the market is supporting higher prices, you have possession of the ball. You have the offensive team on the field. When you have the ball, your job is to take as much money away from the market as possible; this is when you must try to score. During times when the market is not supporting higher prices, you have in essence lost the ball and must put the defensive team on the field. During such periods, the market's job is to take as much money away from you as possible. Think for a moment about your favorite football team. How well would they do this season if they operated with only the offensive team on the field in every game? They might do well when they had possession of the ball, but when the opposing team had the ball, your team would be scored on at will. The net result is your season would be lackluster at best. This is the problem most investors have. They don't know where the game is being played, much less which team is on the field. Let's face it—most American investors only buy stocks,

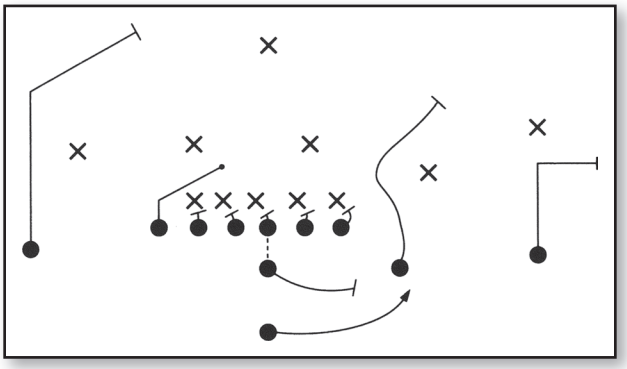


FIGURE 6.2 Game Plan

they never sell short. The market is fair. It has something for everyone. It goes up and it goes down. The NYSE Bullish Percent signals when the environment is ripe for offense or defense. I want to stress that there is a time to play offense and a time to play defense. You must know which is which.

How the Bullish Percent Concept Developed over Time

The need for a soulless barometer started with Earnest Staby in the mid-1940s. He was thinking about the market indicators in existence and determined there was a problem that needed to be addressed. He reckoned that if one were to look at any chart of the broad averages, whether it was a Point and Figure chart, bar chart, line graph, or candle chart, they all looked bullish when the market was at its absolute top, and, conversely, they all looked bearish when the market was at its absolute bottom. He determined that we needed a soulless barometer that would guide us to become more defensive at market tops and more offensive at market bottoms. A contrary indicator if you will. Well, Earnest was not able to come up with this soulless barometer, but A. W. Cohen did in 1955.

What Cohen was trying to create was a market indicator that was bullish at the bottom and bearish at the top. Something that was totally contrary to how most investors operate in the market. Normal trend charts of indexes like the Dow Jones and the Standard & Poor's (S&P) 500 are always bullish at the top and bearish at the bottom. Thus, trend charts of market indexes invariably lead investors to buy at the top and sell at the bottom. Here's how the Bullish Percent concept works. It is contrary and goes against the prevailing wisdom. Most market pundits think the Point and Figure method is a trend-following system. It is not that at all in the initial stages of investment. What this method endeavors to do through the Bullish Percent indexes is to buy stocks when they are washed out and virtually everyone has denied them. Kind of like a value investor might operate, not the other way around. Although once a stock does make a move off the bottom and starts a long-term uptrend, it can be bought along the way. But the method tries to initiate the buying of stocks when they might be considered value stocks whose momentum has recently turned up for the better. If a stock is moving up off the bottom, as it gains sponsorship at the price of, let's say, 40, it will likely be good at 45, 48, 50, or even higher. Remember, stocks that are the first to double in a bull market are typically the first to double again. So

this method of analysis that is really a contrary investment style turns into a trend-following style once the vast majority of stocks have moved off the bottom. The fact that you did not catch a stock at the bottom doesn't mean you are out of the ball game. I have always wondered why a value investor would not incorporate technical analysis in his decision-making process. The value player suggests that the stocks that he buys will eventually be recognized as a value by other investors and as a result will have their price bid up. What if no one sees it like they see it? I'll tell you what will happen. The stock will go nowhere. Why not put the list of value stocks together and wait until the supply-and-demand relationship of the stocks begins to change to where demand is in control. That would be an aces back-to-back trade, a whole lot better than Texas Hold 'Em poker.

The NYSE Bullish Percent is simply the percentage of stocks trading on the NYSE on Point and Figure buy signals. Think back for a moment to Chapter 3. A bullish chart is one where the last signal is a column of X's that exceeds a previous column of X's. If you simply thumbed through all the Point and Figure chart patterns of the stocks on the NYSE and counted the ones that were on buy signals, and then divided by the total number of stocks evaluated, you would have the NYSE Bullish Percent reading for that day. A sixth-grader could do it. We have computers that do the counting for us. Let's say there were 2,000 stocks on the NYSE and 1,000 of them were on Point and Figure buy signals. The Bullish Percent would be at 50 percent (1,000/2,000 = 50 percent). Each box constitutes 2 percent, and the vertical axes runs from 0 to 100 percent. That is the football field we are playing on. When the index is rising in a column of X's, more stocks are going on buy signals suggesting sponsorship is increasing in the market.

Think about what actually takes place if the index is in X's at 50 percent this week and over the next week rises to 52 percent. Changes in the index can only come from first signals that are given, not subsequent signals. What do I mean by first signal? Let's say XYZ stock is on a sell signal, bottoms out after declining, and then gives that first buy signal off the bottom. That signal turns the stock from bearish to bullish (see Figure 6.3). It is this first buy signal that is recorded. All subsequent buy signals are not counted—one stock, one vote.

To be sure you understand how this index can move from 50 percent to 52 percent, let's theoretically cut the number of stocks trading on the NYSE down to 100. Over the next week, 12 stocks experience a new buy signal like the one shown in Figure 6.3, and 10 stocks experience new sell signals. The net result of the action for the week is two net new buy signals

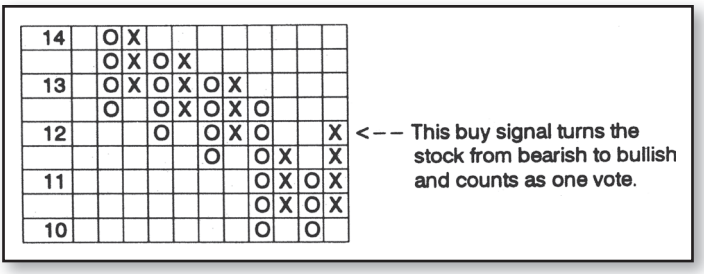


FIGURE 6.3 Bearish to Bullish Pattern

(e.g., 2 percent more stocks went on buy signals than went on sell signals). Remember that each box on the chart represents 2 percent, so a 2 percent net change in new buy signals allows the chart to rise one box. Think about the importance of what I just said. I get questions all the time about how this Index correlates to the Dow Jones or the Nasdaq or the S&P 500. It doesn't correlate at all. These indexes are either price weighted or capitalization weighted. In the case of the Dow Jones, the highest-price stock has the most votes. In the Nasdaq and S&P 500, the stocks with the largest capitalization have all the weight. It can take only a handful of stocks to move these indexes. Let's say IBM was bought out tomorrow 100 points higher than it is at today's close. Do you think it would have an effect on whether the Dow Jones rose or not that day? It sure would. The Dow Jones Average would rise tomorrow, but it would be only one stock that was causing all the action. If the top 20 highest-capitalization stocks in the S&P 500 went up sharply one day, the S&P 500 would rise as well. Now, what does this type of action do to a basic chart of these indexes? It obfuscates reality, that's what it does. If IBM were bought out tomorrow 100 points higher than its close today, it would only count as one positive stock on the NYSE Bullish Percent Index. It would have virtually no effect on moving the index. It is important to keep the Bullish Percent separate in your mind versus indexes that are, in essence, a measure of performance of a handful of stocks. The Bullish Percent is an assessor of risk in the market, not performance. This is the main difference.

Why Use the Bullish Percent versus a Chart of an Index?

One of our clients sent us an interesting article by James Surowiecki entitled, "The Financial Page Markets Always Outsmart Mavens" (*The New Yorker,* October 9, 2000). Although the article is 12 years old, it is timeless in its observations. That article had an interesting take on the markets

and Long-Term Capital Management. That firm had a bond trader named John Meriwether and some of the smartest minds on Wall Street, yet the fund managed to blow up. The author compares the TV show *Who Wants to Be a Millionaire?* with Long-Term Capital. The premise of the show is simple. Contestants pick one of four answers to a trivia question, with the value of each question getting greater until they reach the final million-dollar question. A contestant who answers a question wrong is out. The show gives contestants three "lifelines." If they are stumped on a question, they can use the lifelines to help them out. One lifeline is a 50–50, which takes away two of the wrong answers and leaves one correct answer and one wrong answer for the contestant to select from. Another lifeline is to call a friend to see if he or she knows the answer, and finally a contestant can poll the audience. To do this, each member of the audience keys in his or her choice for the right answer, then the computer displays what percentage of the audience voted for each answer. What the show's producers have found is that when the participant phones a friend for an answer, the person is right two thirds of the time. When the contestant polls the audience, however, they are right 9 times out of 10. So what gives here? Your super-smart friend is right less often than an audience of people who come from all walks of life and have diverse educational backgrounds.

In short, you are more likely to find right answers from a diverse group of people than from one person you deem to be extremely bright and well rounded. As Surowiecki says in the article,

> Long-Term specialized in esoteric trading strategies, which meant that most of the time there were relatively few people it could trade with. If you want to buy stock in Cisco Systems, there are lots of folks out there who will sell it to you at a reasonable price. But if you want to buy, say equity volatility (don't ask), as Long-Term did, there are really only four or five dealers in the entire world who buy and sell this stuff. And they all know one another. These people may have been financial wizards, but, as Millionaire demonstrates, if you want to find the answer to a question—like "What's the right price for equity volatility?" you're better off asking a big, diverse group, rather than one or two experts.

Keep in mind that two of the principals of Long-Term Capital Management are Nobel Prize laureates.

You can test this phenomenon pretty simply with an old trivia game, "How many jelly beans are in the jar?" Surowiecki asserts in his article that a

college professor does this with his classes and invariably the collective guess is within 3 percent of the actual number. At each of our Advanced Point and Figure Institutes, we conduct this experiment. First, we have an intern count out peanut M&M's into a large jar and write down the number. Then, the eight people in the office guess how many M&M's are in the jar and we average those guesses. At the Institute, we then ask the attendees to write down their guesses and we average those. In one of our latest Advanced Point and Figure Institutes, the average guess of the eight people teaching the seminar was 840. At the seminar, in which there were 80 attendees who all voted, the average guess was 1,398. Now, get this—the number of M&M's was 1,396! We found it absolutely amazing that the group came so close. We took all the guesses and applied the statistical concept of a bell curve to it. What we saw was a perfect bell curve. There were some outlying guesses, but the collective guess was right on the money. Again, the larger the sample, the better the average guess. It's played out this way each time we do our "M&M study."

Norman Johnson, a physicist at Los Alamos National Laboratory, quantified this hypothesis. He built a computer-simulated maze in which a person could navigate in numerous ways and tested people's ability to get through it. Johnson took the sample group and found what he called the "collective solution." In other words, he took the turn in the maze that the greatest percentage of people picked. This "collective solution" was just 9 steps long compared to an average of 34.3 steps the first time a person worked through the maze. Furthermore, he found the bigger and more diverse the group, the smarter the collective solution was. As Surowiecki points out in his article, "The miracle of markets is that a hundred million ordinary people, just by going about their daily business, end up allocating resources much more efficiently than would five guys talking on the phone, no matter how smart those five guys are." Or as Michael Mauboussin, the chief investment strategist at Legg Mason Capital Management put it, "The market is smart even when the people within it are dumb." Does this speak in any way about the wisdom of the politicians we elect? Maybe the best way to solve world problems is through a collective vote of all Americans on the Internet. Hey, don't laugh; it might solve the European crisis and future elections and I'll bet it could solve our energy crisis, too. The problem is that it wouldn't get any incremental votes for politicians, so I'm sure it will never be tried.

Our Bullish Percent concept relies on the same approach as the jellybean, M&M, and maze tests. The larger and more diverse the sampling, the

better or more accurate picture we get of risk in the marketplace. We view the Bullish Percent as "polling the audience" in the *Millionaire* show, while the most often quoted market indexes take the "phone-a-friend" solution. The audience members get it right more often than the phone-a-friend, and that is what we see with the Bullish Percent—it is better at assessing risk in the market than the indexes. Remember, it is the risk in the market we are assessing, not the market's performance. Each week when we calculate the Bullish Percent reading we are in essence polling our audience, which happens to be the NYSE (or OTC) stocks. This audience of about 2,000 for the NYSE market and 3,000 for the OTC market is better at assessing risk than the top 20 capitalized stocks in the S&P 500 or Nasdaq 100. Remember, the bigger the sample size, the more accurate a picture you get. Each week, we ask the stocks comprising the NYSE (OTC and markets all over the world) what is the correct level of the Bullish Percent. Should it be 50 percent, 70 percent, 30 percent, or somewhere else? It is then up to us to interpret the reading and decide what type of strategies we want to integrate.

Mechanics of the Bullish Percent

Let's go back to the mechanics of charting the index. We use the same three-box reversal to shift columns in this index as we do in the normal Point and Figure chart; however, we do not look for chart patterns in this index as we do in the individual charts that make up the index. We do, however, watch for double bottoms and double tops. I'll explain in a minute. Field position and the column you are in are the two most important considerations. Remember, the only way to switch from one column to the next is through a three-box reversal. Since each box in the NYSE Bullish Percent is worth 2 percent, it would take a sum total of 6 percent net buy or sell signals to cause a reversal. Reversing from one column to the next is tantamount to losing or gaining possession of the ball.

The chart is made up of columns of X's and O's with the vertical axes running from 0 to 100 percent. We think of this as a football field consisting of 100 yards. There are two things we try to ascertain with this chart: (1) who has the ball (offense/defense)? (2) What is the field position (current level from 0 to 100 percent)? If you colored the area above the 70 percent level in red and the area below 30 percent level in green, these would

represent the two extremes much like the end zones of a football field. The higher the index climbs, the more overbought it becomes because more and more investors become fully invested, and those investors who are inclined to sell tend to hold off. The lower it drops, the more oversold it gets because more and more people who have an inclination to sell do, and those who have an inclination to buy hold off. When the index is rising in a column of X's, we say you have possession of the football. When you have possession of the ball, you must run offensive plays. This is your time to attempt to score against your opponent, the stock market. When the index is declining in a column of O's, the market has the ball and your job is to try to keep it from scoring against you. The numbers within the column of X's or O's on the chart represent months of the year, so you can see the time spent in a column of X's or O's is generally a number of months, not weeks.

It is important to fully understand this index, so let's go back to our discussion about how the index rises and falls. It takes a net change in buy or sell signals to move the index. The minimum percentage move in the index is 2 percent to advance a box or decline a box. It requires a 6 percent net change between new buy and new sell signals to change columns. This 6 percent change is the critical part of how this index moves from column to column. Typically, I look at the index as a gauge of how many players are on the field. It is interesting to look back to 2007. In February 2007, the Bullish Percent hit a high of 74 percent. The Dow Jones made an intraday high of 12,759 that month. In October 2007, the Dow Jones made an intraday high of 14,166. However, as the Dow Jones was about 1,400 points higher here, the NYSE Bullish Percent only managed to get as high as 62 percent in October 2007, making a lower top. We saw this same type of action in 1987. The net of it all was the Dow Jones went to new highs with fewer soldiers on the field. You know what happened after that. The meltdown of 2008 was waiting in the wings. These are telltale signs the market gives to those who are paying attention.

NYSE Bullish Percent Risk Levels

There are six degrees of risk in the index similar to the different signals a traffic light can give. A. W. Cohen felt if the index were rising in a column of X's and above the 50 percent level, the market was bullish. Conversely, if the

index were declining in a column of O's and below the 50 percent level, the market was bearish. Earl Blumenthal fine-tuned the NYSE Bullish Percent to include six degrees of risk. Working with this index over the years I have found that field position and whether the index is in X's or O's is about as complex as you need to get with this concept. For this reason, I am leaving out the risk levels in this edition.

Earlier, I mentioned that we watch for two patterns—the double top and double bottom. It is significant when the Bullish Percent goes into a period of weakness (reverses into O's) and then reverses up (into X's), rises to the previous level that caused the supply to come in, and exceeds that level (double top). We would give added value to this condition. Conversely, I would say the same thing with the double bottom. Don't try to think too deeply into it. Suffice it to say that when the Bullish Percent is in X's below 50 percent the field position is better than when in X's above 50 percent. When in O's, the field position is worse above the 50 percent level than it is below 50 percent. It's just logical. Keep it simple. Who has the ball and how is your field position? That is the most important guidance the Bullish Percent can provide.

Lessons from the Bullish Percent

As mentioned, my conviction in the Bullish Percent has only grown stronger through years of experience with different markets. In this fourth edition, we have tacked on another five years of experience watching it guide us through even more market conditions we had never seen before. As a result, our own confidence level has just continued to build. You can gain this confidence level too by studying different market periods and how the Bullish Percent reacted. If you take the time to read and study the market scenarios I am about to lay out, you will be miles ahead of the average investor in understanding how the markets work. Keep in mind that this index is for "perspective," not day-to-day trading.

1987—The Crash

I discussed the crash of 1987 earlier because the NYSE Bullish Percent Index saved our company and would have helped any investor avoid the crash if they had been following it. We were only 10 months old at DWA and had just begun to acquire some clients. We decided when we started the company that our main market indicator would be the NYSE Bullish Percent Index.

That index was the soulless barometer we would hang our hat on. If it had worked so well since it was developed in 1955 by A.W. Cohen, and was well founded in the irrefutable law of supply and demand, why should we look any further? On September 4, 1987, the indicator reversed into a column of O's (Figure 6.4) and suggested we put the defensive team on the field. It

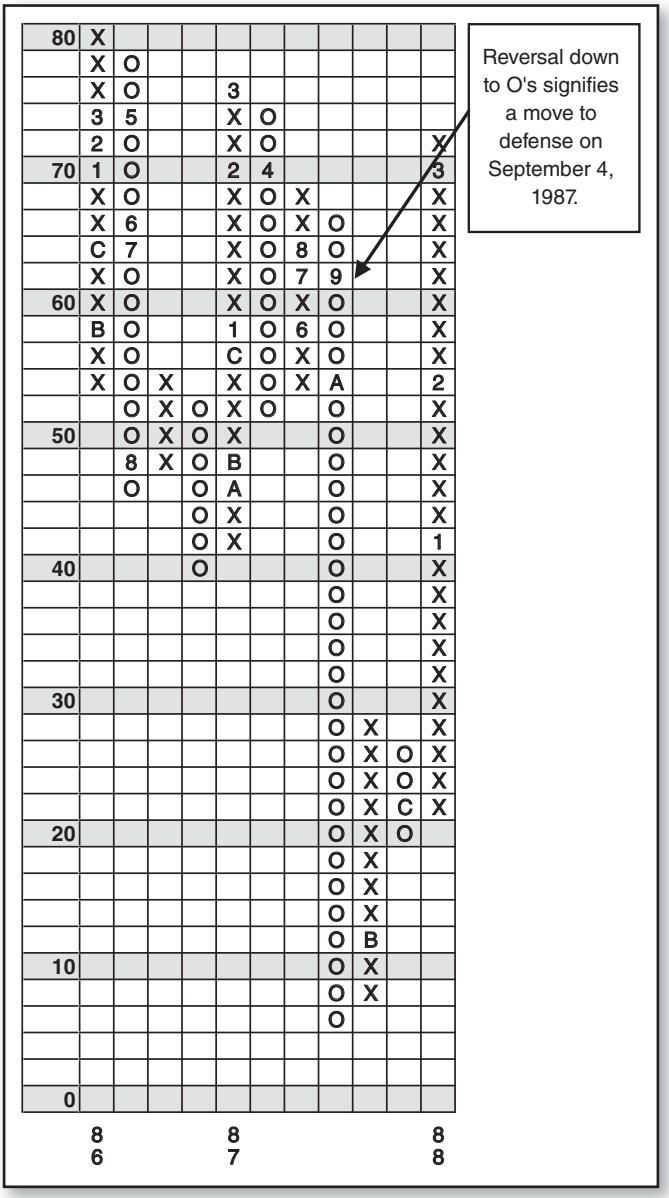


FIGURE 6.4 NYSE Bullish Percent: 1987

was our head coach so we followed the signal without any reservation. From that day forward, the feature articles in our *Daily Equity and Market Analysis Report* had to do with how to hedge a portfolio with options. The following month the market crashed, and I'll be the first to tell you we had no idea the decline would be so severe. Nonetheless, those who chose to follow our recommendations were prepared. The crash took no prisoners from our client base. This was a major confidence builder for us. We knew then we were on the right track. I'll never forget that day.

By the first week in November, the same indicator that had suggested defense on September 4, 1987, now suggested offense. This was just as tense as the sell signal the index had given us a couple of months earlier. All the newspapers, magazines, and TV shows were talking about depression, recession, 1929, no hope for Wall Street, and on and on. The media did their part in scaring investors, right at the time our head coach (NYSE Bullish Percent) told us to begin running plays. It was a great example of how the market looks ahead. The Bullish Percent Index reversed up into a column of X's and, once again, we knew of nothing else to do but follow it. Those who followed our recommendation to buy got back in right at the bottom. I must add there was no brilliance on our part for those calls on the market; it was the NYSE Bullish Percent that did it. We simply followed its guidance like football players follow the guidance of their coach. Ultimately, the most credit should go to the late A. W. Cohen for creating this index in 1955. Along the way, this method of analysis became a lost art that I revived in my first book.

After the crash, we put together a marketing piece consisting of excerpts from our report pre- and postcrash. This marketing piece, in essence, opened doors for us. From that day forward, the NYSE Bullish Percent has been the mainstay of our market indicators. I have written many articles on it, and each time I write about it I learn a little more. We have used this index to guide our intermediate market action for over 25 years now. We have seen it work in bull, bear, and neutral markets. The more you learn about this index, the more confidence you will have in your day-to-day market operations.

1990—Kuwait Invasion

We really need to begin the discussion of 1990s market by going back to 1989. In September 1989, the NYSE Bullish Percent hit 74 percent (Figure 6.5). Exceeding the 70 percent level put this important indicator into the red zone. In October 1989, everything changed. Six percent of the stocks on

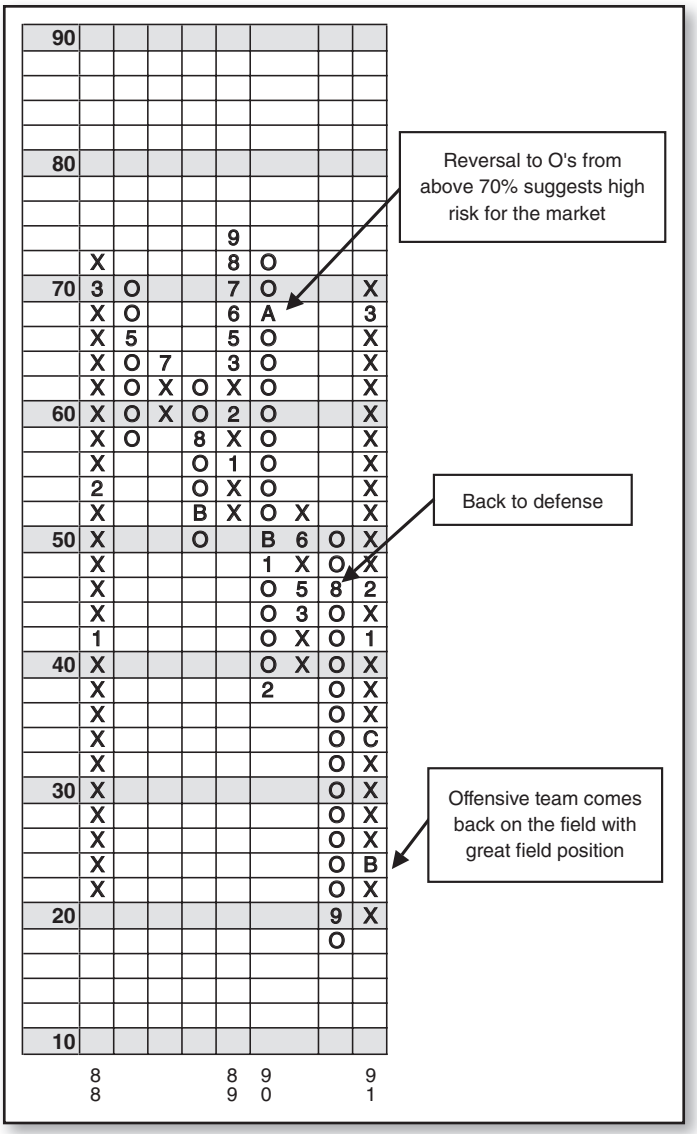


FIGURE 6.5 NYSE Bullish Percent: 1989–1990

the NYSE moved from buy signals to sell signals and put the defensive team on the field. The initial move down carried the NYSE Bullish Percent down to 38 percent in a straight column of O's. By March, there was a slight reprieve. The NYSE Bullish Percent reversed up from March until August when, on the day of the invasion of Kuwait, the NYSE Bullish Percent reversed down into a column of O's, putting us back on defense. The thing about defense is you never know how bad it will be until it is over. For that

reason, we always take the posture that it is better to preserve capital and lose opportunity than it is to lose money. Opportunity is easy to make up, but money is hard to make up. A 50 percent loss in a stock means you have to gain 100 percent just to get back to even. The NYSE Bullish Percent just continued to experience more sell signals and more sell signals until it was finally driven down to 18 percent in September. The Bullish Percent stayed at that level until November when it reversed up into a column of X's. I distinctly remember watching the financial news and hearing Alan Greenspan tell the American public that we were in a recession at the exact time our main market indicator was reversing up from oversold levels. The difference between economics and Wall Street is that economics reports on what is happening today, while the financial markets look ahead. The Bullish Percent was telling us that the recession was not just beginning, but rather it was nearing an end.

After the NYSE Bullish Percent reversed up from that 18 percent level to 24 percent, it rallied straight up to 70 percent. This is one of the few times the NYSE Bullish Percent has fallen to such an extremely low level and then rallied straight up to 70 percent. This is why we always take positions on any reversal from below 30 percent. Who knows when that move might end up going coast to coast? Usually we see an initial rally up off the bottom and then a retest that results in a higher bottom. When the NYSE Bullish Percent reached 70 percent, the risk management process started all over again. This points out how the Bullish Percent is an oscillator and not a trend chart, and why you cannot compare it to an index like the S&P 500. Keep the concept of a risk assessor firmly in your mind as you evaluate this chart.

1994—Stealth Bear Market

The market of 1994 has been dubbed the "stealth bear market." The indexes were holding up, coming in even for the year, but the sector rotation in the market was unbelievable. As one sector was getting hit, another was recovering from its sell off; the effect of this was to cancel each other out in the broad market indexes. However, the individual stocks and many investors did not fare as well. The market during 1994 was one in which you came into the office and sat down and crossed your fingers that it wasn't your stocks that got taken out behind the shed and shot. The reality of the market was that 80 percent of the stocks on the NYSE were down 20 percent or more at some time during the year. The NYSE Bullish Percent was in a column of O's for

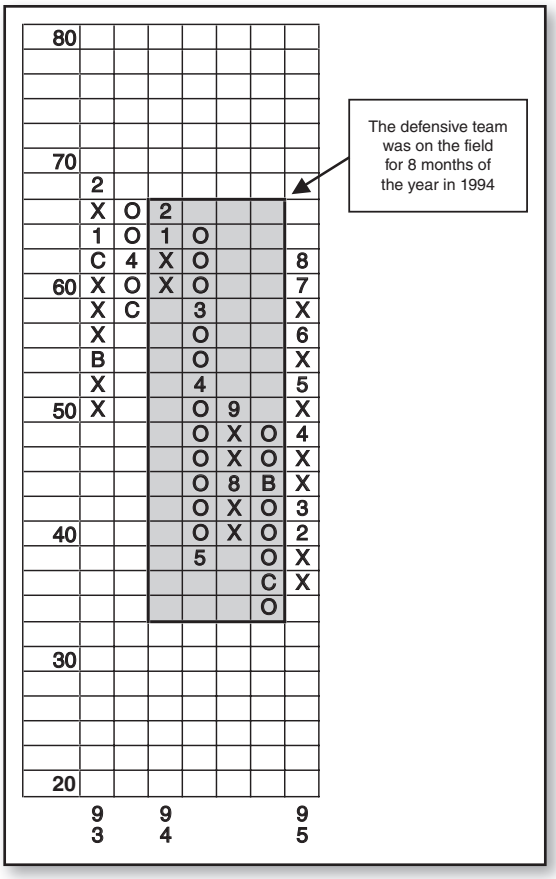


FIGURE 6.6 NYSE Bullish Percent: 1994

eight months out of the year (Figure 6.6). That means that for two thirds of the year we were playing defense. In 1994, the NYSE Bullish Percent started out the year at 66 percent. Is this good field position or bad field position to start out the year? It's bad field position. By the end of the year, the NYSE Bullish Percent was at 32 percent. You might ask, "Why wasn't the Bullish Percent lower than 32 percent if 80 percent of the stocks were down 20 percent or more that year?" The reason is that many sectors bottomed at different points in time. Some sectors, like drugs, bottomed out in the spring; others, like technology, bottomed in the summer, and yet other groups bottomed out in December. While some sectors were moving to sell signals, others were moving to buy signals, and those buy signals had the effect of canceling out some of the sell signals, thus keeping the NYSE Bullish Percent from getting down to a reading of 20 percent or lower. Nonetheless, what was the field

position going into 1995? Good field position. In 1995, the NYSE Bullish Percent and other indicators had us playing offense for 70 percent of the year (36 weeks out of the year, the NYSE Bullish Percent was in X's), and certainly the market did quite well with the Dow Jones up 36 percent. In 1996, it was a similar story as the NYSE Bullish Percent was in X's 39 weeks that year, 75 percent of the time. The S&P 500 was up 20 percent that year. In 1997, the NYSE Bullish Percent was in a column of X's for 35 weeks or 65 percent of that year, and in general, it was another good year for stocks, except for the Asian flu financial crisis, which hit in October 1997. Before the market crumbled from the Asian flu, the NYSE Bullish Percent gave us notice having reversed in O's from the 76 percent level. That reading of 76 percent was the highest for the NYSE Bullish Percent since 1987.

1998—Indexes versus Stocks

The year 1998 showed another major change with respect to the NYSE Bullish Percent (Figure 6.7). What I find so interesting is that there are always different catalysts that seem to make the market rally or stumble, but that doesn't matter to the NYSE Bullish Percent. Those catalysts are always rooted in the supply and demand relationship within the market, and that is what the NYSE Bullish Percent is designed to measure. I'll never forget the 1998 market. By April of that year, the NYSE Bullish Percent had risen to 74 percent. We began to see selling pressure build up as more stocks were going on sell signals versus buy signals. A change definitely was in the offing. Reversals from above 70 percent are particularly concerning. On April 1, 1998, we wrote in our daily research report, "It Wasn't Raining When Noah Built the Ark." I saw this euphemism on the marquee of a Baptist church as I was going to lunch one day. I felt as if the pastor had put it up there for me to read. We always keep our eyes open for that marquee as we drive by because the pastor of the church is incredibly creative with respect to his euphemisms. This one hit me right between the eyes because it was perfect with regard to what the market was on the verge of doing. We needed to have our professional clients begin to think about what they would do to protect their clients when this index moved to defense. Our intention was to get our clients to begin considering risk management/damage control—what to do when things go wrong. We could see the Bullish Percent was close to reversing to defense. It was like doing lifeboat drills on a cruise ship. The first thing you do when you embark on a cruise ship is participate in lifeboat

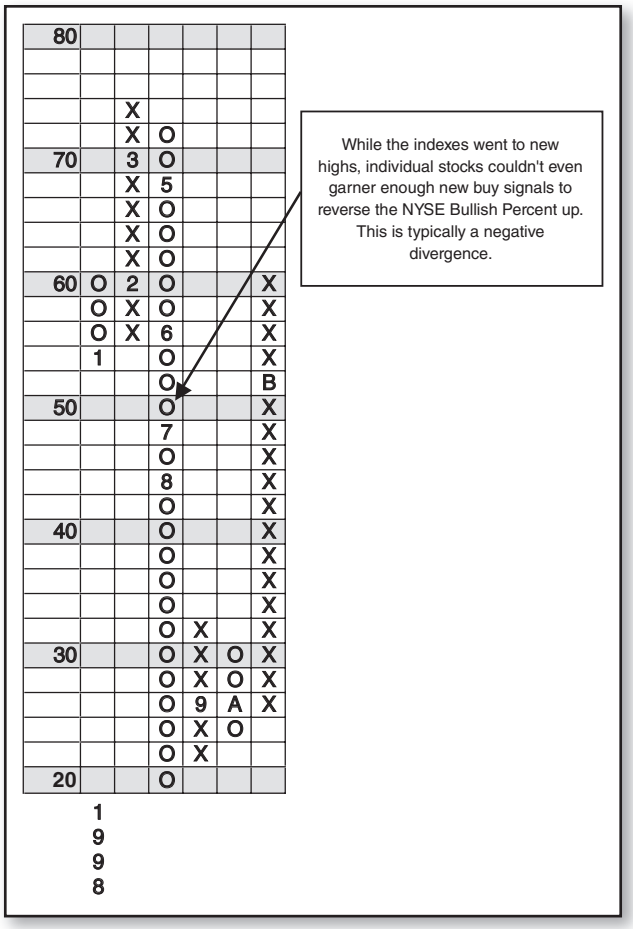


FIGURE 6.7 NYSE Bullish Percent: 1998

drills that deal with what to do if the ship begins to sink. Our outlook was the same. Plan what to do if the market begins to sink so your portfolio won't go down with it.

By May 7, 1998, the NYSE Bullish Percent Index had reversed to a column of O's signaling defense. The Index then marched straight down to 20 percent, which is an extremely washed-out condition. In July of that year, the Dow Jones rallied to all-time highs, as did the Nasdaq, NYSE, and S&P 500. The trend charts of these indexes looked very good, but the reality of the situation was that more sell signals were piling up while a handful of stocks pulled these indexes to new highs. It was as if the generals were in the battle but the soldiers had left the field. Those who followed the Bullish Percent Index were dead on the money, playing defense, while others who followed the

trend charts of these indexes were on the wrong road with the offensive team on the field. This "major" rally that took these indexes to new all-time highs only lasted two weeks. Shortly after the highs were made, the market caved in. Or should I say, those indexes caved in. The market had been declining since April 1998. As mentioned, the Bullish Percent eventually went down to 20 percent before we experienced a reversal during the month of September.

2000—The Two-Sided Market

The year 2000 was interesting, indeed. The NYSE Bullish Percent had been making lower tops since its peak in 1998 at 74 percent, and by February 2000 the NYSE Bullish Percent had fallen to 34 percent, just above the green zone or low-risk level (Figure 6.8). Then in March 2000, the NYSE Bullish Percent reversed up while the OTC Bullish Percent reversed down into O's. We had a situation in which we went from offense to defense on the OTC Bullish Percent while going from defense to offense on the NYSE. In March, we also saw

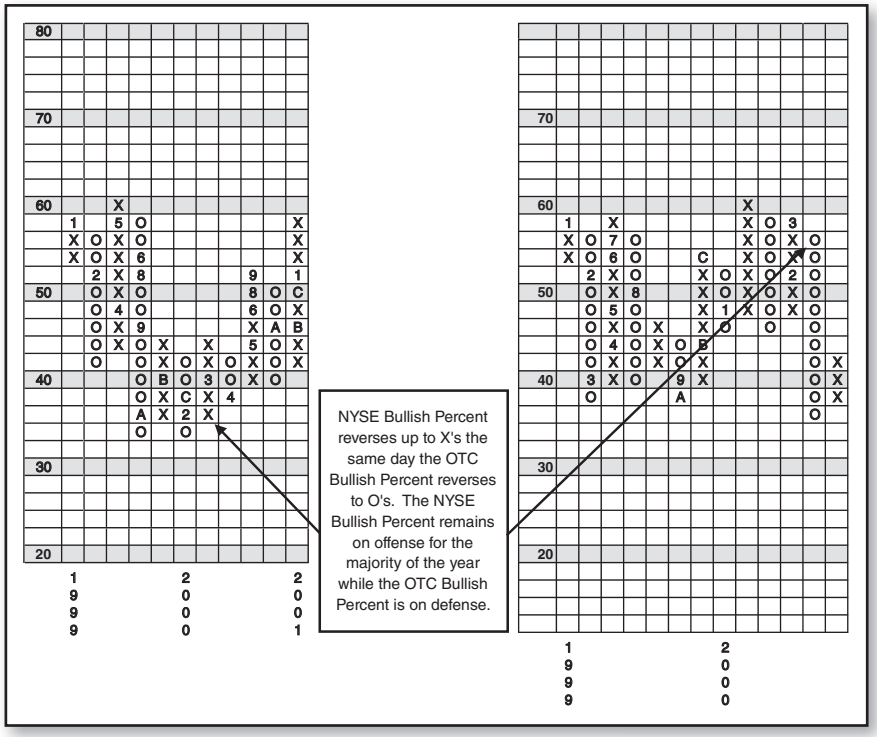


FIGURE 6.8 NYSE Bullish Percent: 2000

some of our other relative strength (RS) indicators turning positive on the NYSE while turning negative on the OTC market. This call kept our clients underweighted in the OTC stocks and overweighted in NYSE stocks while most of the investing public was doing just the opposite and getting killed. As mentioned, the years 1995 to 1997 saw the NYSE Bullish Percent in a column of X's 70 plus percent of the time, keeping the offensive team on the field for those stocks for three quarters of the game. During 1998 and 1999, though, it was a different situation. During those years, the NYSE Bullish Percent was only in X's about half of the year. In other words, we had the ball for 50 percent of the game and the market had the ball for 50 percent of the game. That's why it was so hard to make headway in the NYSE stocks during 1998 and 1999. But in 2000, we saw a switch back to investors having possession of the ball for 75 percent of the time. Here is the reason for this. The RS of small-cap stocks overtook that of large-cap stocks. This was the first change in the market favoring small-cap issues in many years. Since the capitalization-weighted indexes are all driven by the handful of stocks with the highest capitalization, this change was imperceptible to the uninitiated. Over the previous years it was the big-tech names that drove the "market." Stocks like Microsoft, Sun Microsystems, Cisco, and the like were the locomotives that pulled the market up. Now it was the little guys, who never have any votes in the capitalization weighted indexes like the Standard & Poor's (S&P) 500 that were taking over the show. In fact, I remember in July 2001 I was on FOX TV Show, *Cavuto on Business,* when Neil Cavuto said, "Tom, everyone I talk to tells me they are losing money in the market. How can that be, when over half the stocks that trade are up, not down?" Well, this was a change in leadership in the market that the media totally missed. The media primarily looks at indexes like the S&P 500 and Dow Jones. If these indexes are going down, then in their eyes the market is not doing well, but in this situation the small-cap stocks were doing fantastic while the large stocks that generally pull the indexes up and down were losing sponsorship. Since that very important change in RS for the small-cap stocks in 2000, they have held the ball virtually all of the time over the next twelve years. From March 31, 2000, to August 31, 2012, the S&P 500 Index (SPX) of large-cap stocks has lost 6.14 percent, while the S&P 600 Small Cap Index (SML) is up 119.15 percent.

During the dot-com craze we saw an increase in the volatility of the NYSE Bullish Percent indicator, and especially the OTC Bullish Percent. Some of this can be attributed to the advent of the Internet craze and technology stock proliferation. Over the past 50 years, there have been times when the index has only changed columns infrequently, like 2003 and 2006 when it

changed columns just two times, or 2004 when it changed direction four times. However, volatility in this index is not unprecedented. From 1960 to 1965, the index averaged about six changes a year. That was during the close presidential race between Nixon and Kennedy. There was reason to believe there was voter fraud in that election. The Daley political machine was involved. During that span of years, 1960 to 1965, we witnessed the Cuban Missile Crisis, the Bay of Pigs incident, and the assassination of President Kennedy. The volatility in the NYSE Bullish Percent ebbs and flows. After the year 2000, when so many investors were absolutely and unequivocally wiped out as the Nasdaq dropped 50 percent from its high and (that is over twice the percentage associated with a bear market) the volatility in the Bullish Percent charts came back to a more normal range until 2008 when it once again picked up dramatically. What we have learned is that volatility doesn't matter. Sometimes volatility increases significantly, and other times it is less but the one constant is that the Bullish Percent concept is still the best method of evaluating the markets, hands down!

9/11/2001

This is a day we will all remember: the day America was attacked by terrorists who hijacked and flew two airliners into the World Trade Center. This act of terrorism caused the markets to collapse. The market did not open back up until September 17, 2001, and by September 21, a mere five trading days later, the Dow Jones Industrial Average had lost 1,543 points or 16 percent of its value. Many investors headed for the hills and sold everything that wasn't nailed down. Since this chapter is on the NYSE Bullish Percent, the question is, "How did this index react during this sharp decline in the Dow Jones?" The answer can be found by just looking at the chart. You will notice that the NYSE Bullish Percent had us on defense since June of 2001 (Figure 6.9). Anyone one who had taken the signal and was operating in a wealth preservation mode went through the attack in relatively great shape. The market had already been in decline when the attack happened. In reality, the attack actually created a bottom in the Dow Jones. It is major events like this that make investors "throw the baby out with the bath water" and often mark the bottom of the market. The problem is, who rings the bell that the bottom has been reached? For us, the bell ringer is the NYSE Bullish Percent. On October 11, 2001, the NYSE Bullish Percent reversed up. What many investors thought would be a long-lasting market decline was only a one-month phenomenon.

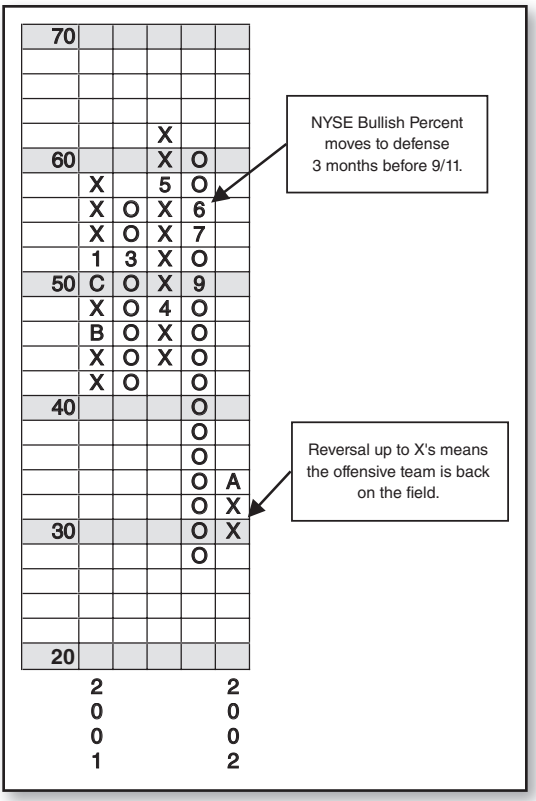


FIGURE 6.9 NYSE Bullish Percent: 2001

2002—No Place to Hide

Just nine months after the NYSE Bullish Percent had reversed up from below the 30 percent level, in October 2001, our main coach was once again knocking at the door of the red zone (Figure 6.10). From the reversal up to X's in October 2001 at 34 percent, the NYSE Bullish Percent marched unwaveringly ahead and by April 2002 was at 68 percent. You know, there's an old market adage that says "sell in May and go away," and what strikes me as I look at the chart of the NYSE Bullish Percent is the frequency of the numbers 2, 3, 4, 5 (for February, March, April, and May) when the NYSE Bullish Percent is nearing the red zone. Be that as is may, we defer to the chart and let it tell us when it's time to get on defense. In 2002, the time for defense was June 3. That is when the defensive team came on the field, and, boy, did our team take a lickin' during the market's possession of the football. It seemed like the market scored against us at will. By July 23 the major indices were down

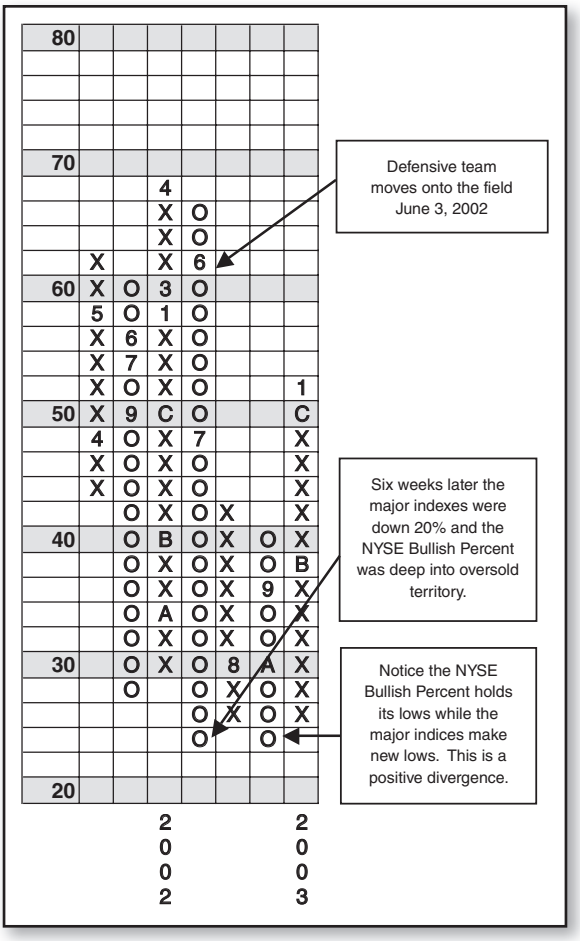


FIGURE 6.10 NYSE Bullish Percent: 2002

20 percent or more and the NYSE Bullish Percent had moved coast to coast, now residing at 24 percent—even lower than the 9/11/01 lows of 28 percent. In 2002, there was no place to hide as just about every stock took it on the chin. In fact, a look at the DWA sectors during that time period show that 68 percent or 27 of the 40 sectors we follow were down 20 percent or more.

In August 2002, the NYSE Bullish Percent saw 6 percent of the stocks move from Point and Figure sell signals to buy signals and reverse this chart up into a column of X's. This suggested that you bring the offensive team back on the field and the field position was ideal, below the 30 percent mark. The NYSE Bullish Percent had an initial move up to 42 percent and then reversed down into O's but this is not unusual (Figure 6.10). In the 23 instances where the NYSE Bullish Percent has fallen below the 30 percent level and

reversed up, we have seen the NYSE Bullish Percent reverse back down and make a higher bottom (or even level) in half of those occasions. But what is interesting is that while the major indices usually make new lows, the NYSE Bullish Percent makes a higher bottom. In October 2002, the NYSE Bullish Percent fell back to 24 percent to test and hold its July low levels while the Dow Jones moved through its lows like a hot knife through butter falling past those July 2002 lows of 7,532 to 7,197. But because half of the time the NYSE Bullish Percent doesn't give us another chance, we have to start moving money back into the markets on that initial reversal up. Remember, since 1955 there have only been 23 instances where the NYSE Bullish Percent has moved below the 30 percent level. That's only about once every three years we get the opportunity to buy at very depressed levels. Of course, without a soulless barometer like the NYSE Bullish Percent, we would have no idea of when supply had dried up and demand moved back into the equation.

2003—Who Would Have Guessed?

In March 2003, the NYSE Bullish Percent resided at the 36 percent level (Figure 6.11) and as a nation we found ourselves heading into war with Iraq. Just as we were entering that war, the NYSE Bullish Percent was reversing up to a column of X's and putting the offensive team on the field as of April 2, 2003. The market in general was taking off quickly, and conventional wisdom was that the rally shouldn't last too long. We were just coming out of three consecutive years of the S&P 500 posting losses (–10.12 percent in 2000, –13.05 percent in 2001, and –23.37 percent in 2002). Everyone's mentality was that this rally wouldn't last—we're in the middle of a bear market. But that kind of thinking can only get you in trouble. Think about this situation for a second. You pull a quarter out of your pocket and toss it in the air. You have a 50–50 chance of heads coming up. Now let's say that you toss that coin three times in a row and tails comes up each time. Does that mean you have a better chance of tails coming up again? No. However, our minds might fool us into thinking that was the case by weighting the most recent action more heavily. However, if you continued to toss that coin for say 500 times, I bet that you would find that heads comes up about 50 percent of the time and tails comes up about 50 percent of the time. In 2003, many investors found themselves not believing their indicators because the recent market action had swayed their beliefs or the geopolitical situation made it seem implausible that the market could experience a rally.

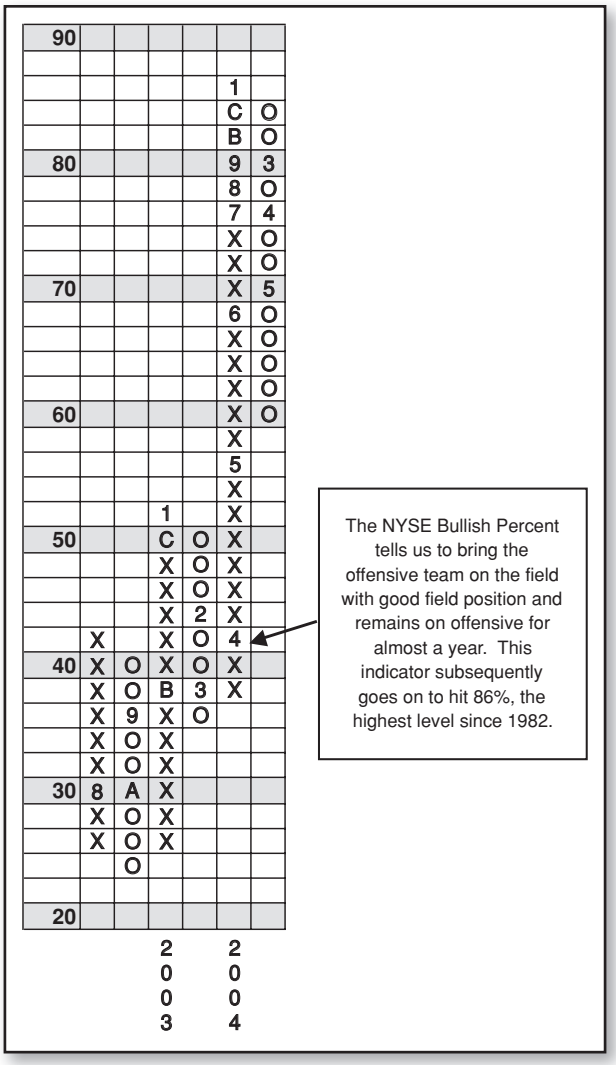


FIGURE 6.11 NYSE Bullish Percent: 2003

What happened in 2003 was the NYSE Bullish Percent stayed in X's for almost a solid year not reversing into O's again until March of 2004 and the S&P 500 was up over 26 percent during that time while the S&P 500 Equal Weighted Index was up over 42 percent. The NYSE Bullish Percent rallied to 86 percent before it reversed into O's. That reading of 86 percent was the highest reading for the NYSE Bullish Percent since 1983. If you had asked me when the NYSE Bullish Percent reversed up in April 2003 if I thought it would go over 80 percent, I would have guessed not, but that is one of the

beauties of the system. It forces us to keep the offensive team on the field as long as we have the football. The fact that this indicator nears the 70 percent level or even exceeds it doesn't mean you sell and move the defensive team on the field. What this does mean is that risk is higher at these levels so you ready the defensive team and select more conservative offensive plays.

2007—The Setup

After bottoming out at 44 percent in June 2006 (Figure 6.12), the NYSE Bullish Percent rallied to 74 percent by February 2007. Then in March, the NYSE Bullish Percent reversed down and fell to 62 percent. The next reversal up in April carried this indicator up to 74 percent again. The Dow Jones was almost 400 points higher, yet the NYSE Bullish Percent couldn't exceed its February 2007 high levels. A reversal down in June saw a swift correction in stocks as the NYSE Bullish Percent fell to 30 percent in the summer of 2007. The Dow was off about 10.7 percent during this time so you can see it was a much worse correction for individual stocks than for the broad averages. By October 2007, the NYSE Bullish Percent had worked itself up to 62 percent but the Dow was exceeding its April levels and pushing up to an intraday high of 14,166.97, higher than April levels around 13,150. What we saw was a case where the generals were the only ones fighting the battle. When I saw the NYSE Bullish Percent was producing lower tops as the Dow Jones was making higher tops, it reminded me of another time in history—1987. This condition will be resolved one of two ways. Either the broad market begins to gain sponsorship and the Bullish Percent Index rises and broadens out, or we suffer a broad market decline. As you know by now, we don't predict, but rather we watch the indicators and govern ourselves according to the risk level of the market and see how things unfold.

When the Bullish Percent gets near or moves above the 70 percent mark, the availability of demand to push the market higher is diminished. An adviser calls their customer with a great idea. It's the newest widget-making company that will change the semiconductor industry. The customer replies, "I love the idea. What should I sell to buy it?" If you sell a stock to buy another, supply and demand cancel each other out. One day you start to sell but decide to keep the cash from the sale in your bank account. You don't replace those sell tickets with buy tickets, and that's what causes the Bullish Percent to reverse down. It's like a pressure cooker when you're above 70 percent. The top on the pot is rattling with

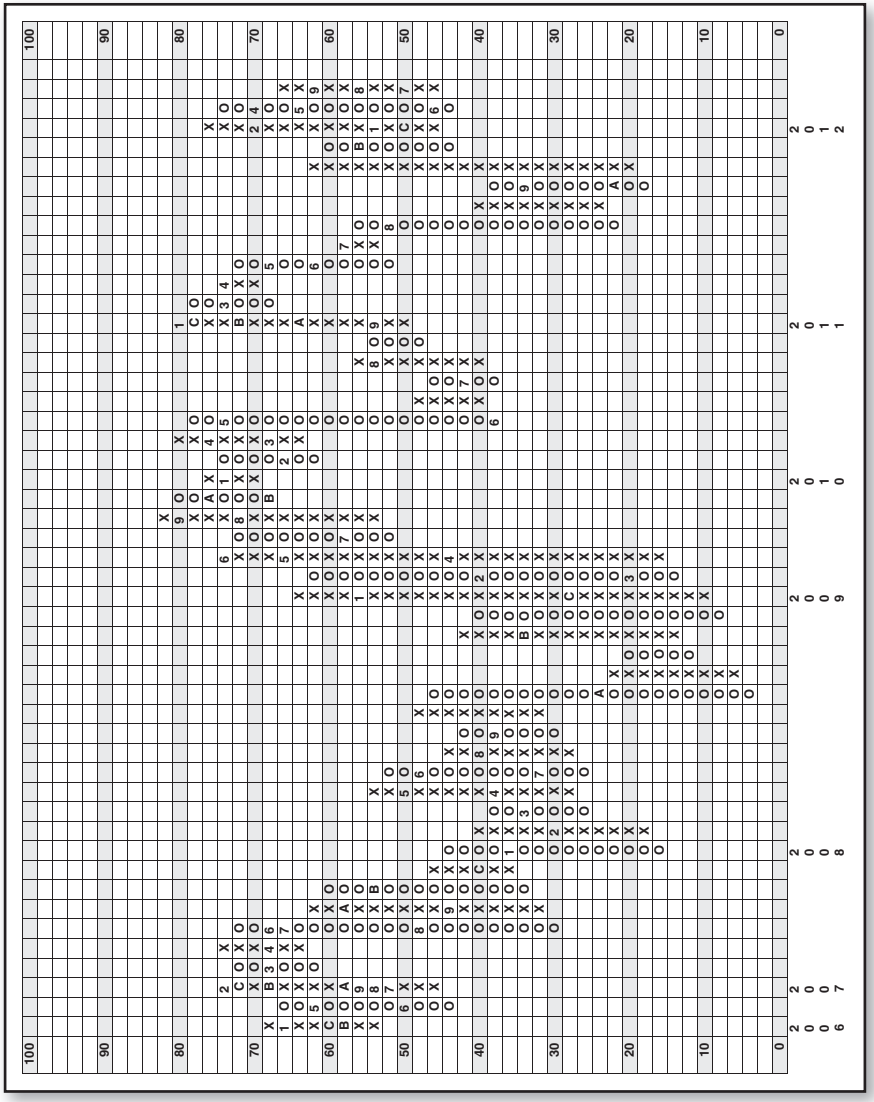


FIGURE 6.12 NYSE Bullish Percent: 2006 to 2012

the steam underneath. One day the steam gets to be too much and the top blows off. We don't know what the cause will be. It may be the Asian flu again, or it may be another type of international crisis like the Iran nuclear bomb situation, or it could be the price of oil, or the Fed chairman's raising interest rates and tightening the money supply. We never know what the cause will be. What we do know is that the risk is high at these levels and we must govern ourselves accordingly.

What does "govern ourselves accordingly" mean? It can mean many things to many people. For those of you who are professionals in the investment business, this is FINRA Rule 2090, the old NYSE Rule 405: Know your customer. What is right for one person may not be suitable for another. There are many right answers. If you are unaware that the indicators are in high-risk territory, you might just continue to buy stocks with unbridled enthusiasm; the financial news media certainly will foster this enthusiasm. It's in their best interest that you remain enthusiastic about the markets. That way, you keep tuning in. Most of us, though, would not take that tack. Here are some ideas that might make sense in market conditions when this index is at high levels. This is the type of commentary we provide in our daily reports:

- *Do nothing.*
- *Tighten up stop-loss points.* As stocks start to give sell signals, you ensure that you don't give back too much of your profits. You might choose to just take partial positions off the table on the sell signal, but by doing that you have taken some defensive action.
- *Take partial profits.* One thing you might consider is selling a third of your position if you are up 30 percent or more. This gives you staying power with the rest of your position to handle a correction. The money you free up acts as a hedge and then you have that cash to reemploy once the indicators suggest you have a good buying opportunity again. As well, taking partial profits will keep one stock from becoming too large a portion of your portfolio.
- *Sell calls against partial or total positions.* This takes the sell decision away from you. You take in premium, which acts as a hedge against you, and you sell at the strike price. If the stock doesn't get called away, you keep the premium and can rewrite the calls. With this strategy, you must be willing to have the stock called away. If you are not willing to have the stock called away, then you're a closet naked writer.
- *Buy protective puts on particular stocks.* Let's say you own Exxon Mobil (XOM). The stock is at the top of its 10-week trading band, the weekly momentum just flipped negative, and the sector is extended and the next support is the 80 area, with the stock currently trading around 90. You or your client might be willing to accept the risk down to 85 but after that want someone else to carry the risk. You might choose to buy a six-month-out put struck at 85. That gives you (or the

client) the right but not the obligation to sell his stock at 85 anytime between now and expiration no matter where XOM is trading. If the stock does in fact fall, you can always take the profits on the put and hold the stock too.

- *Buy protective puts on a portfolio.* Ask anyone if he or she owns a put and the answer would likely be no. Ask the same people if they own a home or a car and you get a resounding yes. If you own a home or a car, you own a put. You own insurance on your home and car. Every six months, you send the insurance company a check to protect you for the next six months should there be an accident. Many people have portfolios worth more than homes and yet they don't even think to buy insurance on their stocks should there be an accident in the market. Let's say you have a portfolio worth $250,000 of blue chip names. Your client says he can handle a 5 percent drop in the market but after that he wants some insurance. The SPX is currently trading at 1,420. A 5 percent drop in that index would bring it down to 1350. One way to hedge the portfolio is to buy puts on the SPX struck at 1350. Each put that you buy protects $135,000 (1,350 times 100) of the portfolio. To hedge a $250,000 portfolio, you would buy two puts. The price you pay for the puts is like the car insurance premium you pay every six months to your insurance company. You hope you don't have to use it but if you do, you're sure glad you have it. Also, you don't have to buy protective puts on the whole portfolio. You can hedge just a partial portfolio.

- *Buy only half positions here and average in the other half on a pullback.* This allows you to at least get your foot in the stirrup in case we don't get a pullback. If the stock does pull back, then you can average in lower.

- *Buy calls or leaps on stocks you want to own.* Let the premium you pay be your stop-loss point and come back at expiration and see how you stand. The important thing to remember here is not to over leverage. If you normally buy 500 shares, only buy 5 calls; don't over leverage by buying 15. Keep the rest of the money in a money-market fund.

- Buy an exchange-traded fund (ETF) that holds the stock you are interested in owning. It will give you more diversification with less volatility. Let's say you are interested in buying a particular oil stock. You can buy an ETF that is simply a basket of oil stocks. This way instead of buying one fish, you buy the whole school of fish.

There are lots of ways to take a more defensive stance. What makes you different from the competition, or other investors, is that you have a game plan. You have a soulless barometer to tell you what plays to run. This is the type of research we put out each day. We try to make sense of the indicators. We never anticipate the anticipators; however, when we see changes in the offing, we discuss what to do if the event does in fact take place. We always try to have the moves we would make in the chess game laid out for us ahead of time so that we don't act like a deer in the headlights when the change does take place.

Every few years, the NYSE Bullish Percent gives us some real opportunities by declining below the 30 percent level. It doesn't happen every year, but when it does, be prepared to buy. The last time it was below 30 percent was in 2011. When will it happen again? We don't know. Like I have said many times in this book, we don't anticipate. We change the players on the field when this indicator tells us to.

2008—A Fateful Year

As I write the fourth edition of this book, it's interesting that years after the market debacle of 2008, we are still reeling from the ramifications. As we started out the year 2008, we knew that something was amiss with equities. As I outlined above, in 2007, the NYSE Bullish Percent made a lower top in October while the Dow Jones was moving to new highs. In late October 2007, the NYSE Bullish Percent reversed down into O's at 56 percent and our Dynamic Asset Level Investing model showed that the relative strength of U.S. equities turned negative versus money market. By January 2008, the NYSE Bullish Percent had worked its way down to the 16 percent level and reversed up to X's. By May the NYSE Bullish Percent had rallied to 54 percent and the Dow Jones Industrial Average (DJIA) had rallied from lows of approximately 11,635 up to 13,136. But this was driven largely by the Energy and Basic Materials sectors. These stocks were still sailing high during the first few months of 2008. In fact, do you remember the financial headlines in the spring of 2008 saying that Goldman felt it was likely oil would reach $200 a barrel in the not-too-distant future? By July 2008 Nymex Crude had reached $145 a barrel before giving a double-bottom sell signal at 136 and then a spread triple bottom at $131 a barrel. Every time the market tried to rally, we just saw a lower top in the NYSE Bullish Percent and lower tops on trend charts, and it was hard to find charts that

were trading above their bullish support lines. All the time, relative strength remained negative on equities suggesting that any time the NYSE Bullish Percent moved into X's, we were likely to only experience only a trading bounce. And trading bounces they were—volatility spike to levels not seen since 2000 and the 1930s. In fact, did you realize that the number of trading days the DJIA experienced movements of 1 percent or greater, either up or down, was 134 days? That ranks fourth since 1896, with only the years 1929, 1931, and 1932 beating it. And, there were 72 days in which the DJIA moved at least 2 percent in a single day and 13 days with moves of 5 percent or greater in a single day! Yet despite all of this volatility, it is amazing that the NYSE Bullish Percent gave us such insights into what was happening in the markets when everyone left their office on Friday during the fall of 2008 and wondered what bank would not make it through the weekend. We'd often tell our interns that they were witnessing history in the markets. Not since the 1930s had we seen something like this.

Ultimately, the NYSE Bullish Percent fell to a low of 4 percent in October 2008. That exceeded the lowest level seen on the chart prior to that when the NYSE Bullish Percent hit 6 percent in 1987. While volatility remained high, the insights this powerful indicator gave us were incredible.

2009—Finding a Bottom

There can be numerous fundamental reasons why stocks sell off and push the NYSE Bullish Percent down into the "green zone" below 30 percent, but ultimately, the only reason that matters is that there were more sellers than buyers willing to buy. Adhering to a pattern that had been developed in the NYSE Bullish Percent back to 1955, the bottom process in 2009 was marked by higher bottoms. As I mentioned before, the NYSE Bullish Percent fell to a low of 4 percent in October 2008. In November 2008, the S&P 500 hit an intraday low of 747.78, lower than its October 2008 intraday bottom of 839.80; however, the NYSE Bullish Percent only fell to 8 percent. Then, in March 2009, the S&P 500 and most major indices hit their sell-off lows. The S&P 500 was at 666.79 on its intraday low. Once again, the NYSE Bullish Percent made a higher bottom though. This time it fell only to the 14 percent level. It was in March and April of 2009 that many of the RS charts began to change back to favoring equities again for the first time in over a year. This suggested it was time to start moving chips back onto the table, but what a hard thing to do when the financial news media was saying the bounce off

the bottom wouldn't last and the magazine covers were extremely negative and fostered a feeling of fear of the markets. Of course, we all know now that the spring of 2009 was a terrific time to put money back to work or, more important, it was a time, if you were still long, not to panic and sell the bounce. The great thing with the Bullish Percent indicator is that if we are wrong and the bounce proves to be just that, a bounce, then the indicator only has to see 6 percent of the stocks in the universe to go back to sell signals to get defensive once again. Because we know that there is a brake in place, it allows us to view this important indicator as a soulless barometer and have confidence in this soulless barometer. Volatility remained relatively high in 2009 but the NYSE Bullish Percent eventually worked its way up to 82 percent by September 2009.

2010–2011

In both 2010 and 2011, the cycle of moving from overbought to oversold territory continued, though the swings were not quite as violent as we saw in 2008. In April 2010, the NYSE Bullish Percent peaked at 80 percent and after reversing down into O's in May at 74 percent, this indicator fell to 38 percent, near the green zone. After a reversal back up to X's and rallying to 48 percent, the NYSE Bullish Percent reversed back down into O's and tested that support level at 38 percent and was in fact able to hold before reversing up and eventually moving to 80 percent in January 2011. The cycle started over again as this indicator eventually fell back to the 18 percent level by October 2011. Yet once again the NYSE Bullish Percent topped out before the broadly followed indices like the S&P 500. In 2011, the BPNYSE hit its peak in January, but the S&P 500 topped out at 1370.58 (intraday) on May 2, 2011. I want to stress what this means. The NYSE Bullish Percent is not a timing tool for the S&P 500. If you want to trade the S&P 500, the chart pattern is going to be one of your best tools. The NYSE Bullish Percent is used to help us assess risk in the overall market. It helps us determine what the best types of plays to run based on who has the football and the field position. The S&P 500 can continue to go up while the NYSE Bullish Percent goes down because of the differences in the weightings in these indices. However, eventually it becomes hard for the broad indices like the S&P 500 to continue to rally when fewer and fewer stocks are participating. Eventually, the SPX fell to a low of 1074.77 by October 2011 when the BPNYSE was hitting that low of 18 percent. That is a drop of 21.6 per-

cent from that May high. When all was said and done in the year 2011, the S&P 500 was flat for the year but the Dow Jones was up 5.53 percent. What happened is that Europeans who felt the heat rising with their incredible fiscal problems looked for a place to go. The only safe harbor, or perceived safe harbor, is in the United States and in particular large cap stocks. These are the Dow Jones stocks. When it storms, these are the stocks where investors seek shelter.

2012 and Beyond

As I write this book, the NYSE Bullish Percent sits at the 66 percent level. It has been a very strong market for U.S. stocks so far in 2013. Through October 5, 2012, the S&P 500 is up 16.17 percent and the PowerShares DWA Technical Leaders Portfolio (PDP) is up 17.92 percent. The NYSE Bullish Percent spent 7 out of 10 months on offense in 2012, and since July it has risen from 50 percent to 66 percent. What we once again see is this important indicator at a lower level when the market averages have moved to new highs. A presidential election is a mere couple of weeks away. We don't have a crystal ball to tell us what will happen in the future. But what we have is immense confidence in a set of indicators that will guide us through any type of market by measuring the irrefutable law of supply and demand that is fundamental to every market.

Bullish Percents around the World

The Bullish Percent concept is a very important one and it is something that can be applied to any universe of stocks. In the United States, we break the markets down into multiple different categories including:

- Nasdaq
- Large-cap stocks
- Mid-cap stocks
- Small-cap stocks
- Optionable stocks

These are just a few of the categories. As a general rule, we like to see at least 100 stocks in any Bullish Percent. We use this minimum so that no one

stock can have too much influence on the reading. Since the first edition of this book, technology has advanced at lightning speed, and that has allowed us to expand our coverage immensely. We chart the entire world and currently have Bullish Percent readings on over 20 different countries. You can see a Bullish Percent chart on Canadian stocks, Mexican stocks, Indonesia stocks, Brazilian stocks, Egyptian stocks, and more. In fact, we even group countries together and do Bullish Percents on regions and other categorizations like Emerging Markets and Developed Markets. The great thing about the concept is that it is portable. The indicator is so robust it can be applied to any place in the world because when you get down to what moves stock's prices, supply and demand speaks any language. I encourage you to get to understand international markets. It will be very important going forward, and you have all the tools at your disposal between chart patterns, relative strength, and Bullish Percents.

CHAPTER 7

Secondary Market Indicators

Secondary market indicators dovetail beautifully with the long-established Point and Figure indicators. With these new indicators, we still use the Bullish Percent concept. We simply apply this concept to the other aspects of a stock's technical attributes that we find essential. I think about it like the dashboard of your car. You'd never be successful in reaching your journey if you didn't keep your eyes focused on the road ahead, which for us are the NYSE and OTC Bullish Percents, but you do need to consult the gauges on your dashboard to make sure the car is performing the way it should be. You probably will find that you most often glance at the speedometer, but periodically you glance at the temperature gauge to make sure the car isn't running too hot, suggesting something might be wrong with the engine internally. You keep checking the gas gauge and RPMs. These gauges are like the secondary indicators we are going to discuss in this chapter. Let's gain some perspective first. Over the years, we have found that relative strength (RS) comparisons are the most important consideration on where to invest your money in the market. This is where we compare and contrast asset classes. It was the year 2000 when Rydex Funds came out with the Equal-Weighted S&P 500. This was major because it allowed us to compare on an RS basis the Capitalization-Weighted S&P 500 vs. the Equal-Weighted S&P 500. Sounds strange, doesn't it—S&P 500 against the S&P 500—but the contrast was stark indeed and led us down a path to extensive use of RS on almost everything that can be compared and contrasted in the global markets. We found that the different weightings in the S&P 500 caused a major difference

in performance in the same 500 stocks. I began, that moment, to be the champion of equal weighting. Today, we compare the world on a daily basis. This has led us to the development of our Dynamic Asset Level Investing concept, which kept us out of equities in 2008. Sometimes you should be in U.S. equities, sometimes not. At other times it is best to have your money deployed in fixed income and commodities, and in still others "cash is king"—as we found out in 2008. All asset classes can become correlated at the same time (there went modern portfolio theory out the window). We have always considered cash an asset class. In the movie *Cool Hand Luke,* Paul Newman says after bluffing in a card game to win: "sometimes nothing is a real cool hand." One of the quotes I like to use from our money management arm of Dorsey, Wright is, "Many times it's what you don't own that is the key to success." We will discuss these concepts of comparing all asset classes on an RS basis to determine where to be in the market in later chapters.

All our indicators are kept on our web site (www.dorseywright.com), so you can refer to them in real time as you read this book. The Internet has truly revolutionized how we maintain and present our charting and portfolio system. It doesn't seem that long ago we kept all these charts by hand. I was just reminiscing with a CPA the other day how we used to update 2,500 charts each day by hand. This was before the advent of fast computers or the Internet. Once we were able to computerize this process, getting my analysts to stop the hand charting was like pulling teeth. They loved seeing the stocks they updated on a daily basis. Every day each analyst rotated the book he or she updated to another analyst. This way, in one week, each analyst saw firsthand 2,500 charts. We did this for a decade before the Internet became popular. Then, we were limited to sheer people power with respect to the number of indicators we could develop, but today's technology has allowed us to limit ourselves only to our imaginations with respect to the way these indicators can be applied to different markets. We now use "cloud computing."Things we did by hand 25 years ago, like updating 200 RS charts a week, can be done in a split second. Think of this for a second. Yesterday we updated from scratch, going back a decade in time, 9,200 stocks, in 9 minutes. If you ponder that for 9 seconds, you will be utterly amazed at what cloud computing can do. Where will we be in 2015? It is like trying to figure just how far a distance one light minute is. We know that light travels approximately 186,000 miles per second, so think of how fast a light minute is. Then think of what one light year means. One light year in the cosmos is like next door, I mean right next door. But when you multiply 186,000 miles in one second by the number of seconds in a year, it's a pretty darn far

piece of road. Our nightly run of millions of pieces of data in a fraction of the time is just as mindboggling as it is to think of how far the Andromeda Galaxy, our closest neighbor, is from us. This has opened the world up to us. In seconds we can compare the world and determine if we should buy Top Glove, the largest rubber glove manufacturer domiciled in Malaysia, or Procter & Gamble. This can be done with the touch of a finger.

While we have added a number of indicators to our repertoire, we are still mindful of the fact that you have to keep it simple. Once a concept is developed and tested, it is then applied to each market, New York Stock Exchange (NYSE), American Stock Exchange (ASE), Nasdaq, sectors, mutual funds, international markets, and even fixed income. But one thing you can be assured of: we never gravitate away from the underlying principles of the methodology—supply and demand; they define our work. We have no need to search for any other concept. We are, however, always looking for other ways to apply the irrefutable law of supply and demand. It's like the hub of a wheel. This hub is the Point and Figure method of analysis with all the associated indicators. From this hub, we attempt to extend as many spokes as we can without ever leaving the concepts that define our company. Many investors make the mistake of trying to follow too many indicators or jump from one to another when one doesn't seem to work. Just about everywhere you turn there is another indicator that someone assures you will make you rich. Just go to the Internet chat rooms and you will be hit with a barrage of information and indicators that will both confuse and obfuscate the picture. The "real deal" is the irrefutable law of supply and demand. There is nothing else that causes price change. Just think about it for a second.

In the previous chapter, we discussed indicators we have used for decades that simply let us know which team is on the field, offense or defense. Those were the NYSE and over-the-counter (OTC) Bullish Percent indexes. Still, they provide much needed perspective. The Bullish Percent concept can be applied to a multiplicity of different areas with differing timeframes. The NYSE and OTC Bullish Percents are our long-term coaches, but within long-term trends it is important to identify underlying currents and shorter-term trends as well. First, we'll start off with a look at some of the secondary Bullish Percent indicators, then our other equity indicators, and end with a review of applying these indicators to the mutual fund markets. I'm going to shorten this chapter versus the third edition because we place less emphasis on it relative to our RS work. Still, they are important to understand and keep track of. Well, actually the computer will keep track of them and let you know what is happening via e-mail or text. I am alerted every day with all the indicators I need

to see on my "Welcome" page on our site. If something has changed to negative, say NYSE Bullish Percent, it will show up in red. If the change is positive, I will see it in green. Then I get a message on my cell phone and e-mail that it happened. I just love it. When I get a message that something has taken place that requires my attention, it makes me smile every time.

Other Equity Indicators

Bullish Percents

Recall the NYSE and OTC Bullish Percent concepts you just read about in Chapter 6. We can apply this Bullish Percent concept to other indices. Three other Bullish Percents that we review daily in our work are the Bullish Percent for the Optionable Stock Universe (BPOPTI), the Bullish Percent for the S&P 500 Index (BPSPX) and the Bullish Percent for the Nasdaq Non-Financial Index (BPNDX). Let's outline a couple of important tenets about these Bullish Percents. Some of this is a review from the previous chapter, but it's important information so it doesn't hurt to have another review.

All of the Bullish Percents are equally weighted, meaning one stock, one vote. The charts measure the percent of stocks that are on a buy signal on their Point and Figure trend chart. Take the BPNDX, for example; there are 100 stocks in this universe. Let's say that 50 stocks are on buy signals. This would result in a reading of 50 percent ($\frac{50}{100}$) on the BPNDX.

No matter what Bullish Percent you are looking at, (BPNYSE, BPOTC, BPSPX, etc.) they are all a measure of risk, not a measure of performance. That is, the BPSPX measures the risk in the S&P 500, the BPNDX measures the risk in the Nasdaq Non-Financial Universe, and so on.

The two most important considerations when using these Bullish Percent charts are field position (whether the reading is 30 percent, 40 percent, 50 percent, etc.) and what column the chart is in (X's or O's). Risk is considered on the high side of the ledger above 50 percent and on the low side below 50 percent.

The Optionable Bullish Percent is a good intermediate-term Bullish Percent that we follow closely. The reason we like this Bullish Percent is that it is made up of over 2,700 stocks that trade options. We don't plot the option prices, but rather we plot the Point and Figure charts of all stocks that have listed options on them. This is a nice cross-section of stocks without one sector influencing too much of this Bullish Percent. For instance, financial-related stocks comprise about 23 percent of the stocks listed on our NYSE Bullish Percent

calculation but only 15 percent of the Optionable Bullish Percent calculation. The technology-related stocks account for only about 5 percent of all stocks in our NYSE Bullish Percent and over 17 percent of all stocks in the OTC Bullish Percent, but in the Optionable Bullish Percent, technology-related stocks are 12 percent of the universe. Often, changes in the Optionable Bullish Percent will precede changes in the NYSE Bullish Percent, so we do take into consideration this Bullish Percent's calculation in our assessment of overall risk in the marketplace. The one time we did not find the Optionable Bullish Percent useful was in 2000. That was because the NYSE and OTC stocks were moving opposite one another and the Optionable Bullish Percent found itself circling around the 50 percent mark for most of the year. With regard to the Bullish Percent charts for the S&P 500 Index and the Nasdaq 100, the calculation is the same as the calculation for the Bullish Percents discussed earlier. However, these indexes have fewer stocks than our broader markets like the NYSE and OTC, so what you will find is that these charts do move much faster.

If you need a little more review of the Bullish Percent concept, feel free to go back and review Chapter 6. It's important that you get this concept because the same principles apply no matter what index you view with a Bullish Percent. It's all the same. Here is how easy it is to keep track of any index if you wish to be alerted to technical changes. Say I wanted to be alerted on my cell phone or e-mail, could be the same, of a change in columns on the Bullish Percent for the S&P 500. I don't need to think about it until it changes. As Figure 7.1 illustrates, simply put a dot in the box below that says on for "column change." Set it and forget it. When you need to know of a change in status you will be alerted. This is beautiful to me. Our online system at DWA extends into management of whole portfolios like this. It's the future right here and now.

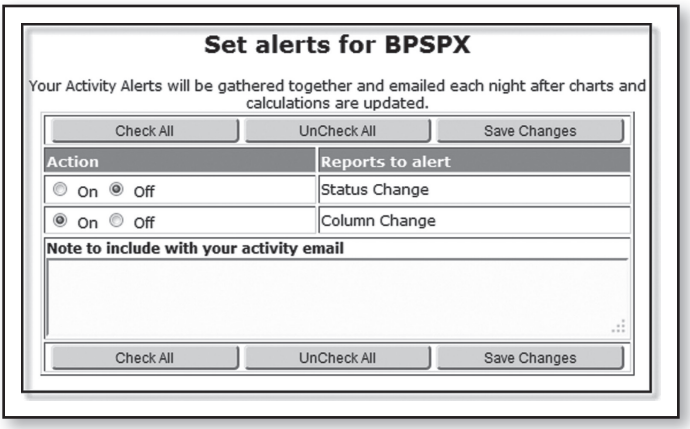


FIGURE 7.1 Bullish Percents: Setting Activity Alerts

The Percent of Stocks above Their Own 10-Week Moving Average Index

This index is one of our most important short-term market indicators. It should be used in conjunction with the High-Low Index. As its name implies, the Percent of 10 is simply made up of the percentage of stocks on any index you are evaluating that are trading above their own 10-week moving average (see Figure 7.2). We keep this indicator for both NYSE and OTC stocks and each sector as well. It is as important to keep abreast of the short-term trend of the overall market as it is to keep abreast of the long-term trend. We use the same grid with this index that we use with the Bullish Percent Index. The vertical axis has a value of 2 percent per box and runs from 0 to 100 percent. The best sell signals come when the index rises above the 70 percent level, then reverses down below that critical level. In cases like this, there is a very high probability that the broad averages have begun a short-term correction. This is significant because the short term often spills over into the long term. Conversely, the best buy signals come when the index declines below the 30 percent level then reverses back up. In the case of the buy signals below 30 percent, the index does not have to cross that level on the upside to be valid. I am more of a longer-term investor, so I don't actually look at this indicator much. It can change too often for me. The older I get, the less I'm interested in jumping around.

What about changes between 30 percent and 70 percent? For example, say the Percent of 10 reverses up from below 30 percent changing the prevailing risk level to a short-term buy signal. The index then rises to 58 percent, where it encounters supply and reverses into a column of O's. In this case, we defer to the broad Bullish Percents. If the NYSE Bullish Percent were still in X's in this case, we would conclude that demand is still in control of the market, but a short pause that refreshes in the market could be expected. Over time, we have found that the most important signals from this indicator tend to come from those changes in the red and green zones, above 70 percent and below 30 percent, and particularly when the index gives a buy signal.

This index is of great benefit when you are planning your trade. Investors, however, should never use the Percent of Stocks above Their Own 10-Week Moving Average Index as their sole indicator in making new stock commitments. Believe me, some people do. They are the quicker-on-the-draw kind of investors. I don't recommend this. Like A. B. Jones

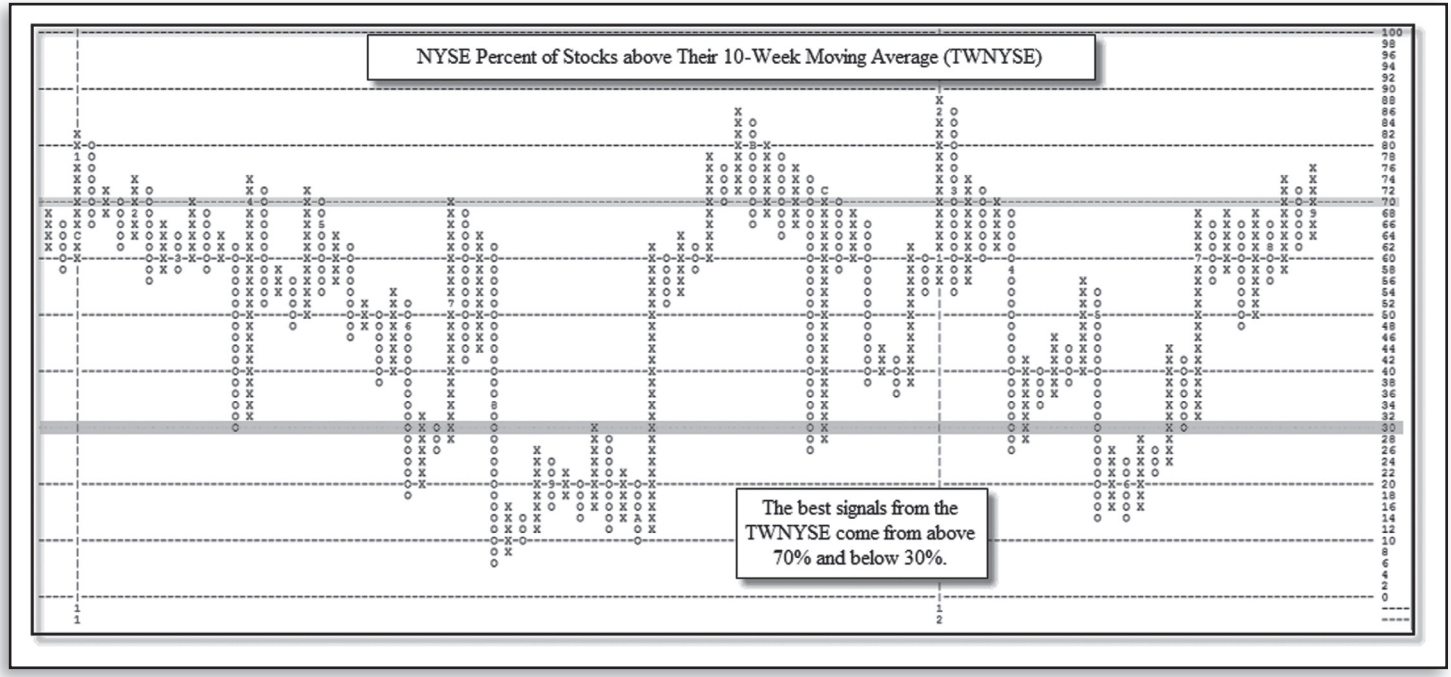


FIGURE 7.2 Other Equity Indicators: NYSE Percent of Stocks above Their 10-week Moving Average

once told me after my first year as a stockbroker at Merrill, Lynch, Pierce, Fenner & Smith: "Tommy, ain't but one way to make money in the market—slowly." I never forgot this, and it is the best piece of advice I have ever gotten in my 37 years in this business. A. B. was a very seasoned broker at Merrill when I was a rookie.

The Percent of Stocks above Their 10-Week Moving Average is used to help us with play selection. The NYSE Bullish Percent tells us which team is on the field, offense or defense, and then, depending on the position of the short-term indicators, the Percent of Stocks above their own 10-Week Moving Average, and the High-Low Index (discussed below), we can get a better idea of which plays to run. For example, let's say the NYSE Bullish Percent is in X's but the Percent of 10 is in O's and has fallen below the 70 percent level. This would tell us that the risk in the market is now a little higher, so perhaps buying 300 out of your 500 share position would compensate for that increase in risk. In the alternative, maybe buying an ETF instead of an individual stock would work better for you. In both plays we are maintaining long exposure. We have just adjusted for the fact that the short-term indicator is in a column of O's.

The High-Low Index

This index is another short-term indicator that we use in conjunction with the Percent of 10. Again, just as with the Percent of Stocks above Their 10-Week Moving Average, we keep a High-Low Index on both the NYSE and OTC stocks. If you wish, you can calculate this indicator yourself. Just take the daily NYSE (or OTC) new highs divided by the daily NYSE (or OTC) new highs plus the new lows. Then take a 10-day moving average of this number and plot that figure on a grid exactly like the Percent of 10 (see Figure 7.3). The vertical axes will extend from 0 to 100 percent. We evaluate it the same way as the Percent of 10. The two critical levels are 30 percent and 70 percent. Buy signals come from reversals up from below 30 percent. Sell signals come from reversals from above to below 70 percent. Buy and sell signals can also come by exceeding a previous top or bottom, respectively. Reversals from above 70 percent suggest that there is a trend change from more stocks making new highs to more stocks making new lows. Conversely, when the index reverses up from below 30 percent, it tells us the number of stocks making new lows is drying up considerably.

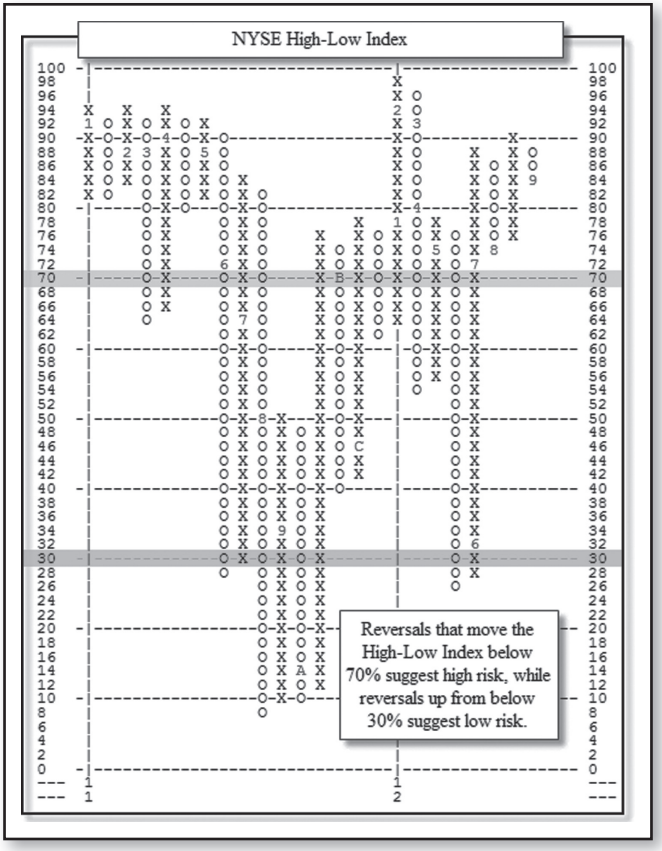


FIGURE 7.3 Other Equity Indicators: NYSE High-Low

There are some other things we want to point out about this indicator. First, to get a good feel for the risk in the short term, we place the greatest emphasis on the signals when the two short-term indicators are moving in tandem. Second, the High-Low can go above 70 percent and remain above that level for some time, even months at a time. Third, this indicator can really move to extremes, hitting 90 percent or higher and also falling to 10 percent or even lower. Fourth, when the NYSE High-Low Index goes below the 10 percent level, it is a sign of a very washed-out market. Think about it for a second. To get to 0 percent we would have to see 10 consecutive days of no stocks hitting new highs. Reversals up from 10 percent are usually good buying opportunities. Figure 7.4 shows the times the NYSE High-Low has been below 10 percent.

While we see the High-Low fall below 30 percent fairly regularly, we do not often see the indicator fall below 10 percent. We like to differentiate

Date	Moved Below 10%	Dow Reading	Low Reading	Dow Reading	Upside Reversal	Dow Reading
March, 1980	3/6/1980	828.07	0.9	800.94	4/10/1980	791.47
September, 1981	8/31/1981	881.46	2.0	849.98	10/7/1981	868.72
June, 1982	6/7/1982	804.03	5.5	795.57	6/24/1982	810.41
February, 1984	2/17/1984	1148.87	7.5	1134.21	2/28/1984	1157.14
May, 1984	5/29/1984	1101.24	5.3	1124.35	6/11/1984	1115.61
July, 1984	7/18/1984	1111.64	5.5	1096.95	8/2/1984	1166.08
October, 1987	10/20/1987	1841.01	0.7	1938.33	1/4/1988	2015.25
January, 1990	1/31/1990	2590.54	8.9	2590.54	2/7/1990	2640.09
May, 1990	5/2/1990	2689.64	9.7	2689.65	5/7/1990	2721.62
August, 1990	8/15/1990	2748.27	3.4	2613.37	9/18/1990	2571.29
November, 1994	11/23/1994	3674.63	5.4	3746.29	12/21/1994	3802.80
August, 1998	8/31/1998	7539.07	4.2	7615.54	9/23/1998	8154.41
October, 1999	10/21/1999	10297.69	7.7	10302.13	10/29/1999	10731.76
July, 2002	7/24/2002	8191.29	7.5	8264.39	8/5/2002	8043.63
August, 2007	8/6/2007	13468.78	8.7	13504.30	8/23/2007	13235.88
July, 2008	7/8/2008	11384.21	4.0	11239.28	7/22/2008	11602.50
September, 2008	9/17/2008	10609.66	1.6	8451.19	11/5/2008	9139.27
January, 2009	1/21/2009	8228.10	0.5	6547.05	3/18/2009	7486.58
August, 2011	8/9/2011	11239.77	6.2	11143.31	8/16/2011	11405.93

FIGURE 7.4 Other Equity Indicators: NYSE High-Low below 10 Percent

between the two by saying that a move below 30 percent represents an "oversold" market, while a move below 10 percent is typically a "washed-out" market. The most recent move below the 10 percent level was August 2011. This was the 19th time the indicator moved below 10 percent since 1980, averaging roughly one occurrence every other year, though the indicator has gone for three, four, and even five years (e.g., the span between July 2002 and August 2007) without dipping below 10 percent. As you can see, when the High-Low does reverse up from such low readings, it typically does not turn around and produce a lower low. In fact, up until 2008, only once since 1980 had this index reversed up from below 10 percent and then come back and made a new low; and that happened in 1984. In that year, the High-Low bottomed at 7.5 percent and reversed up in February of 1984, only to fail and make a lower low at 5.3 percent in May of the same year. In 2008, a similar situation occurred in that the NYSEHILO fell below 10 percent in July and reversed up, only to move to new lows in October and then again in February 2009. Otherwise, you can see that reversals up from below the 10 percent level have been good signs to reenter the market with new positions.

The Percent of Stocks above Their 30-Week Moving Average Index

The NYSE Percent of Stocks above Their 30-Week (150-Day) Moving Average is a longer-term indicator for the NYSE universe of stocks. As its name suggests, this indicator measures the percent of stocks that are trading above their 30-week moving average. Let's say that the 30-week moving average of a stock is 50. If the stock's price is above 50 we say that it is above the 30-week moving average. Once we do this for all the stocks in the NYSE (we also do it for the Nasdaq market), we plot the percent of stocks above their 30-week moving average on a grid from 0 percent to 100 percent. Like the other indicator charts that we follow, there are two lines of demarcation on the chart: the 70 percent level and the 30 percent level. The 70 percent level and above is the red zone or high-risk area. The 30 percent level and below is the green zone or low-risk area. Like the NYSE Bullish Percent, the 30-Week does not get to either of these extreme levels very often, much less to the very overbought or oversold conditions of 80 percent or 20 percent. The NYSE 30 has reached the 80 percent level 19 times since 1970. Typically, the 80 percent level has been seen only in very strong markets in which almost all stocks rally.

There is another interesting phenomenon about the NYSE 30-Week that we want to bring to your attention. Dan Sullivan of the *Chartist* found that when the Percent of 30 goes above 80 percent and then falls below 60 percent, it will see 40 percent before it sees 80 percent again. This has happened 19 times and 18 out of 19 times the 80-60-40 Percent Rule has worked. When this phenomenon has happened, it has occurred before important, often severe, corrections in the market. For instance, in October 1982, the Percent of 30 went above 80 percent and then fell below 60 percent in August 1983, which was the beginning of a year-long decline in the market, carrying the NYSE Bullish Percent below 30 percent before another lift off in the market in 1984. The Percent of 30 also saw this action, above 80 percent, below 60 percent, in April 1987 before the crash of '87. It was also a very early warning of the 1998 crash. In 2007, the start of the 80-60-40 Rule occurred when the Percent of 30 fell below 60 percent, after hitting 80 percent in November 2006. This was foreshadowing for the negative events to come and it was not until October 2008 that the indicator bottomed out at 4 percent, a level bettered only by 1987 when the Percent of 30 hit 2 percent. In Figure 7.5a, you can see a list of each time the NYSE 30-Week has seen

Date Above 80%	Fell Below 60%	Fell Below 40% Before 80%?	Ultimate Low
December, 1970	May, 1971	Yes - July, 1971	November, 1971 - 12%
March, 1972	April, 1972	Yes - June, 1972	October, 1972 - 28%
January, 1975	August, 1975	Yes - August, 1975	September, 1975 - 26%
February, 1976	June, 1976	Yes - October, 1976	November, 1976 - 38%
April, 1978	October, 1978	Yes - October, 1978	November, 1978 - 8%
July, 1980	December, 1980	Yes - February, 1981	September, 1981 - 10%
October, 1982	August, 1983	Yes - February, 1984	May, 1984 - 20%
January, 1985	August, 1985	Yes - September, 1985	September, 1985 - 34%
March, 1986	July, 1986	Yes - September, 1986	September, 1986 - 30%
March, 1987	April, 1987	Yes - September, 1987	October, 1987 - 2%
February, 1991	August, 1991	Yes - February, 1994	December, 1994 - 24%
July, 1997	December, 1997	Yes - July, 1998	September, 1998 - 12%
May, 2003	April, 2004	Yes - May, 2004	August, 2004 - 34%
November, 2004	March, 2005	Yes - May, 2005	May, 2005 - 40%
November, 2006	March, 2007	Yes - August, 2007	October, 2008 - 4%
June, 2009	February, 2010	No	February, 2010 - 52%
March, 2010	May, 2010	Yes - May, 2010	July, 2010 - 24%
November, 2010	May 2011	Yes - June 2011	August, 2011 - 8%
February, 2012	May 2012	Yes - May 2012	June, 2012 - 30%

FIGURE 7.5a Other Equity Indicators: NYSE 30 Week, 80-60-40 Rule

the 80-60-40 phenomenon occur as well as the corresponding Point and Figure chart in Figure 7.5b for the last two times this indicator saw the 80-60-40 phenomenon.

I want you to keep thinking throughout this book about how technology can do most of the work for you. You can set an action alert on the Percent of 30 Index for a reversal just as we did above for the BPSPX.

The Advance-Decline Line

The advance-decline line is a nonprice measure of the trend of the market. It is based on the number of issues advancing and declining and not on the price of these issues. Every day, the difference between the issues advancing and the issues declining is calculated. If more issues advanced than declined, the difference is added to the preceding day's total; if more issues declined than advanced, the difference is subtracted from the previous day's total. We keep advance-decline lines for the NYSE, ASE, and Nasdaq markets. We look at the advance-decline indicators in two ways. First, we look to see if the level is above that of 10 days ago. If it is, then we say that market's

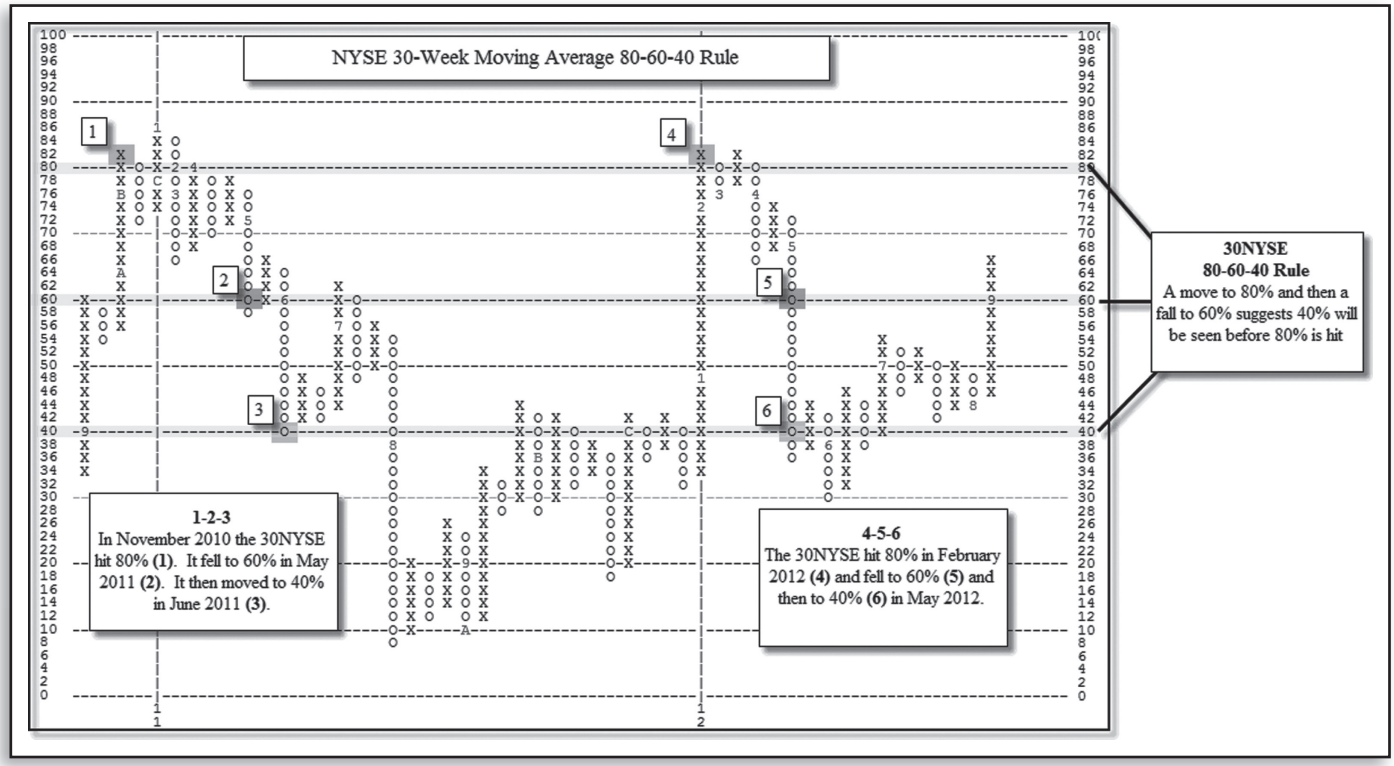


FIGURE 7.5b Other Equity Indicators: NYSE 30 Week 80-60-40 Rule Point and Figure Chart

advance-decline line is positive on a short-term basis. Second, we look at a Point and Figure chart of the advance-decline line. If the chart is on a buy signal, we say the advance-decline for that market is positive longer term. If the chart is on a sell signal, we say the advance-decline for that market is negative longer term. In addition to looking for double tops and double bottoms on the chart, we also take into account high-pole and low-pole warnings. We like to look at advance-decline lines because they, like the Bullish Percent, give each stock one vote. While the Dow Jones or Nasdaq Composite may be going down, what are most of the stocks doing? The advance-decline lines give us insight into the "true market" and not just an index of 30 stocks or so.

Average Weekly Distribution/Normal Distribution

Regression to mean—it's a natural progression that we all go through in our lives. Just the other day I was on my way to Washington, D.C., from Richmond, Virginia. The two-hour drive north was going quite smoothly. There was relatively no traffic, no police running radar, and the weather was sunny. The conditions were right to make good time, so I pushed the envelope and ended up speeding. I get just outside of Washington, D.C., and there was an accident. Darn, foiled again. I had just been regressed to mean. Have you ever gotten too big for your britches? Come on, be truthful. We all at times become too full of ourselves and all of a sudden we get figuratively slapped down. We get regressed to mean. Something happens to make us aware we are getting a little out of control and we settle back to normal.

It's life's way of keeping nature in the center of the curve. As we discuss this think of a bell curve. In a particular field there might be a certain number of rabbits. As they begin to reproduce, their numbers grow geometrically. The more rabbits in one particular field mean the available food supply decreases as a percentage for each rabbit. The rabbits reproduce until starvation kills some off. This is life's way of regressing the rabbits back to normal once the population becomes too large. Not only starvation has a normalization effect on the rabbits but the wolves also show up when the population becomes oversized. The wolves in the area cause the population to regress past the mean to the endangered side of the equation. The wolves leave because their food supply is gone, and the cycle begins again. This is how the stock market works.

One of the best ways to graphically represent this movement back and forth to mean is with the 10-week trading band. We all remember the bell curve concept from our college Stats 101 class. Given a set of data, we can construct a range, which is depicted as a bell curve. There are six standard deviations to the bell curve (Figure 7.6). Three standard deviations to the left are considered 100 percent oversold. Three standard deviations to the right are considered 100 percent overbought. The middle of the curve is normal and most of the time stocks reside within one standard deviation of normal. (Hint: the best strategy most of the time is a neutral strategy [i.e., covered writing]. We'll talk a little bit more about that later.) For each stock and index, we can take 10 weeks' worth of data and create a bell curve. When a stock gets to the overbought side of the curve, it will typically move back to the middle. There are two ways a stock or index can get back to the middle of the curve. First, the stock can fall in price and move back to the middle of the curve. Second, as time passes, the stock can stay relatively the same in price and the curve shifts. Conversely, when a stock or index gets oversold, you will typically see it move back to the middle in one of those two ways. As a general rule, you will see strong RS stocks trade between the middle and the top of their trading bands. Most of the time you will see weak RS stocks trade between the bottom and the middle of their trading bands.

Since every stock in the DWA universe is plotted on its 10-week trading band or bell curve, we can obtain a calculation of where the average stock lies on that bell curve. This chart is called the Weekly Distribution (WD) chart. What the WD chart does is take a simple average of where all the stocks are on their 10-week trading band. For instance, if there were two stocks in our universe, one at −100 percent (100 percent oversold) and

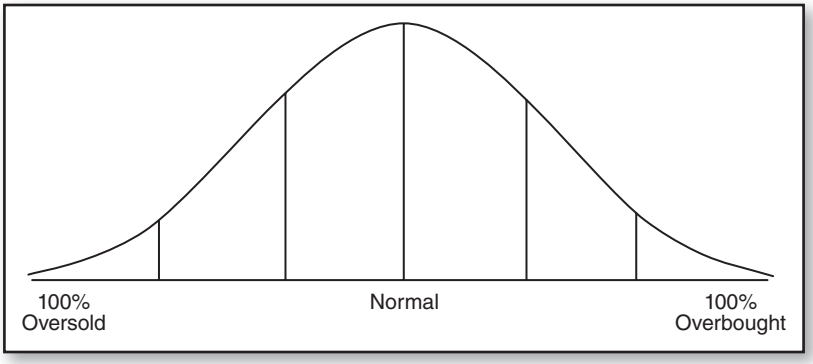


FIGURE 7.6 Bell Curve—Normal Distribution

one at 100 percent (100 percent overbought), then the average would be 0 percent. Using the symbol WDALL you can access this chart at any time on the DWA system.

If a stock were three standard deviations above normal it would be considered 100 percent overbought. Conversely, if a stock were three standard deviations below normal, it would be considered 100 percent oversold. The middle of the curve or normal is considered 0. These three areas depict the range of the 10-week trading band where Top is 100 percent overbought, Bot is 100 percent oversold, and Med is the 0 percent point, or the middle of the statistical bell curve. So, if we were to see a reading on the average WD chart of 0 percent, this would mean that if you were to flip through individual stock charts by hand, what you would find is that the average stock is going to reside at the middle of its trading band. A reading of 0 percent means that the average stock is neither overbought nor oversold as nature has regressed the stock back to mean. A reading of 50 percent, for instance, would mean that the average stock is 50 percent of the way between the middle of the trading band and the top of the trading band.

Looking at the Weekly Distribution for All Stocks, especially over a period of years, we can get a feel for when the average stock, and thus the overall markets, are a little high and due for a pullback or a little low and due for a bounce. We have found that this chart tends to reside between the 50 percent (overbought) and –40 percent (oversold) levels. When the average stock is up in the 30–50 percent overbought territory, we tend to see near-term pullbacks in the market as stocks have rallied in a condition like this. Conversely, we have seen market bottoms come when the indicator is approaching the –40 percent level. As a sidebar, to get to levels of –70 percent or more, the drop in the market must be extremely swift and severe like October 2008 and August 2011, for instance. The Weekly Distribution for All Stocks chart is a secondary indicator to the Bullish Percents, the Percent of Stocks Above Their 10- and 30-Week charts, and the High-Low Indices, but we find this chart especially helpful in gaining an overall perspective of the market on a near-term basis. We should also note that the WD chart is available for sectors as well. The format for this chart is WD, and the first four letters of the DWA sector. For instance, WDBIOM would be the WD chart for the biomedics/genetics sector. Take it one step further and the WD can be calculated on any portfolio you wish to enter in our portfolio system.

Statistics 101 is one of the few courses in college that made sense to me. Economics 101 was the other. The rest were designed to demonstrate that I could hang in there for four years and find the answers I needed to find. Back then, in the early 1970s, there was no Internet and no handheld calculators. So in Stat class we had to do everything by hand. There is much to be said for that. To this day I can write out longhand the formula for a standard deviation. I can do it in my sleep. Today, any calculator will do the work for you. It is interesting that the bell curve concept for the stock market dates back to 1900 in Paris, France. Louis Bachelier in 1900 wrote the thesis for his PhD at the Sorbonne University in Paris, called *The Theory of Speculation*. He is today considered the father of financial mathematics. In his thesis, he postulates that markets in motion cannot be evaluated statistically. However, if one were to stop the motion of the market (i.e., take a snapshot of it), one could apply statistical analysis to it and determine the next highest probable move. I paraphrase his thesis as it really takes a mathematician to truly understand this stochastic process.

Alternatively, it made total sense to me when the late Jim Yates (in my opinion one of Wall Street's unsung heroes) created what he called the zone theory. It was brilliant, just as brilliant as Bachelier's thesis at the Sorbonne University. The reason Yates's zone theory was so brilliant was that we mere mortals could understand and use it. Jim used the term *zone* to replace standard deviation because the words *standard deviation* scare people. *Zone* does not. What Jim created was elegant. First, he worked backward through the Black-Scholes model of option pricing to determine the "implied volatility" of the underlying stock attached to that option. The implied volatility would supplant the basic statistical standard deviation. *Standard deviation* is simply another term for volatility. Anything we evaluate statistically will fall on a bell curve. We can evaluate male heights in the world, people's blood pressures in the world, stocks, anything you wish. By doing this you find that 68 percent of the time what you are evaluating is what I call "middling." I mean hanging around the center of the bell curve. With respect to men's heights, some of us are too tall and some of us are too short, but 68 percent of us are huddled around the middle. Stocks are the same way. Most of the time they are not doing much; they go up, then down, then up again, and then down some, and in the end 68 percent of the time you will find them within one standard deviation above or below trend. Or, said another way, most stocks 68 percent of the time will be found in zone 3 and zone 4. The

bell curve is made up of six standard deviations or zones. Too low is zone 1, too high is zone 6, dead center is the line between zone 3 and zone 4. You will find stocks distributed over this curve. Some will be oversold, some will be overbought, most will be "middling," and so on. Sometimes the majority of stocks will be pushed to the overbought side of the ledger. Sometimes the majority of stocks will be pushed to the oversold side of the ledger. When this happens we expect a regression to mean. This can happen two ways. Either the market corrects back to the center or the curve (being dynamic) will rise or fall to the market level thus making what was much oversold or overbought normal. Understanding where the market, sector, group of stocks lie on their own bell curve can give you great perspective on managing the risk of that group of stocks. I know this falls outside the purview of Point and Figure, but I have used both together for 35 years.

Here is what is so cool about what Jim Yates did. We have recreated the concept on our site. Jim would begin with an individual stock. Each stock has its own bell curve. Considering its individual volatility, a stock has an expected trading range. Let's say utility stocks have taken a drubbing of late because interest rates have risen. Selling pressure overtakes buying pressure, and the move is on. The sector and thus the stocks in the sector decline in price, pushing them to the oversold side of the ledger on their expected trading range (i.e., bell curve). Conversely, let's say, gold stocks rise significantly. These stocks are pushed to the overbought side of their ledger. Other sectors move up, some move down, and some stay the same.

Now let's build a big bell curve encompassing all the stocks in the S&P 500. Think of this slowly. I want to place every stock in its rightful place under this big "mother bell curve," which contains all of the S&P 500's constituents. So say E.I. du Pont de Nemours and Company (DD) is dead center of its own bell curve; we would say it is perfectly normal at this price. Now I place DD dead center of the big S&P 500 curve by typing DD on the line between zone 3 and zone 4. I continue with 499 other stocks in the same way. Say FirstEnergy Corp. (FE), a high-quality utility company, is residing three zones below trend or center, we will type its symbol "FE" on the far left hand side of the curve, and so forth. Now look at the bell curve in Figure 7.7 of the S&P 500 Index September 2012. Notice how it is skewed to the right-hand side of center. We simply say the market is overbought and will in some way correct back to center. Stocks with the highest relative strength will reside on the right-hand side and will be best for trading. Stocks with the lowest RS will reside on the left side and be better for longer-term plays. Naturally, the Point and Figure work must be combined here but you get the concept.

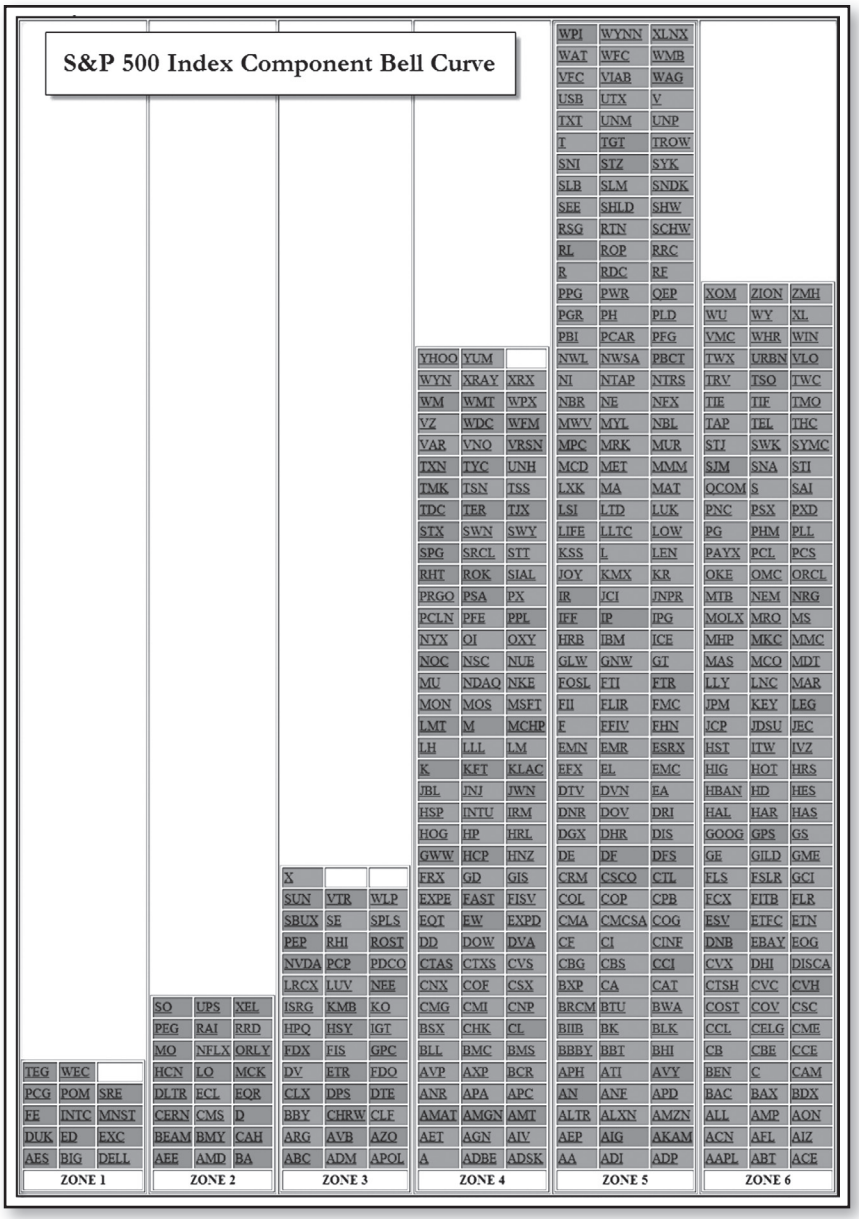


FIGURE 7.7 Normal Distribution: S&P 500 Index Bell Curve

Summary of the Indicators

Now let's stop for a second and allow this discussion to seep in, because I know that we have covered a lot. We have talked about several different concepts and indicators that can be applied to the NYSE and Nasdaq markets as

well as to sectors. I make sure I have alerts set on all indicators. Remember, today, let technology do the work. You will be amazed at how you can still have your life, and do what you want to do while managing your retirement plan or trading account. Yes, you can have it all.

I do want you to start a routine of evaluating all market indicators on a daily basis but it is no longer necessary to do it by hand. On your Welcome page you will find all the indicators lined up for you and updated each night before you wake up in the morning (See Figure 7.8). It only takes a second to scan them. And once again you can set alerts on anything that has a chart so you can simply wait for that e-mail or text message to alert you. Technology increases productivity to the nth degree.

You would be surprised that some changes in indicators take months, not days or weeks, to change. Changes in the NYSE Bullish Percent are like moving an aircraft carrier, not a jet ski. But when those changes occur, it is important to heed them and take action where necessary. If you become very comfortable with these indicators and the types of strategies you want to employ when changes do occur, you won't have the "deer in the headlights" syndrome. You will intuitively understand what used to baffle you. John Mason, best-selling author and motivational speaker, once said, "Lack of decisiveness has caused more failures than the lack of intelligence or ability." I think this is so true of investing and in life.

I use to play golf but just never could get into it like many of my friends did. I tried it for a few years; I loved being on the golf course, but playing never truly interested me. I think I would have been happy to pay for the golf cart for a day and just pack a lunch and drive around the course, relax, think about things in beautiful solitude, and return the cart when I was finished. But many of you who are reading this do play golf and will understand the quote I'm about to give you. Many of you have probably read some of Robert J. Rotella's works. He was the director of sports psychology at the University of Virginia and is a consultant to many professional golfers; he also writes extensively about golf. One of Dr. Rotella's tips that stayed with me was, "It is more important to be decisive than to be correct when preparing to play any golf shot, particularly a putt." Though I do not golf much these days, I do play a lot of pool, and the same quote applies to this game as well. Life on Wall Street means that you will not be correct every time. However, you must not let that keep you from sticking to your game plan, and you must not allow yourself to second-guess your tactical moves. One of the problems with pursuing perfection is hunting for the perfect method. Trying a new system each week will not get you to your goal. It requires remaining focused on one method and maintaining

Market Indicator Status

NYSE BP	66% Xs (act. 67.23)	- 0.30
NYSE PT	62% Xs (act. 62.08)	- 0.15
OTC BP	50% Xs (act. 51.46)	+ 0.05
All Stocks BP	58% Xs (act. 58.42)	- 0.27
Option BP	62% Xs (act. 62.38)	- 0.23
NYSE 30 Wk	72% Xs (act. 68.88)	- 1.45
NYSE 10 Wk	82% Xs (act. 77.47)	- 1.70
NYSE High-Low	96% Xs (act. 95.74)	- 0.46
OTC High-Low	84% Xs (act. 84.40)	- 0.60
OTC 30 Wk	58% Xs (act. 57.41)	- 0.75
OTC 10 Wk	70% Xs (act. 68.52)	- 1.87
S&P BP	78% Xs (act. 78.76)	- 0.40
NDX BP	72% Xs (act. 71.00)	0.00
World BP	52% Xs (act. 52.27)	- 0.08
World PT	46% Xs (act. 46.22)	+ 0.15
DJ Corp Bond	Os 121.06	- 0.01
Eqty Fds Sht Tm BP	96% Xs (act. 96.62)	+ 0.05
Eqty Fds Int Tm BP	94% Xs (act. 94.05)	+ 0.09
Eqty Fds Lg Tm BP	80% Os (act. 85.55)	+ 0.11
Eqty Fds PT	92% Xs (act. 93.14)	+ 0.10

FIGURE 7.8 Summary of the Indicators: Market Indicator Status

consistency and discipline. You may find that Fibonacci numbers, Gann angles, or astrology work for you, and that is fine. But once you find the method that you are comfortable with, you must stick with it. We find the Point and Figure method works the best for us, because it is firmly cemented in something we can easily understand and know is true—the irrefutable law of supply and demand. If you begin to second-guess your playbook, you are doomed to lose the game. Take those principles you have practiced and implement them when the time comes. Remain true to yourself—win, lose, or draw. Nothing is right every single time, but the objective is to be more right than wrong and to stack as many odds in your favor as possible.

When you are evaluating the indicators each week, think about some of the scenarios that might occur. If there are more indicators in X's and rising for each market, then I know I have the football and can run plays. If the indicators are in X's but all near the 70 percent level, then I know the risk is high and I need to make sure the defensive players are well rested and ready to come on the field at a moment's notice. If the majority of the indicators are in O's and falling, that tells me we have a weak market and I should continue to employ wealth preservation strategies. If the indicators are in O's but all below 30 percent, then I need to begin formulating shopping lists of ideas to begin buying once the indicators reverse up. What you will find is that some indicators move faster than others, and when major changes in the market occur, it is like a puzzle coming together. When you dump out a puzzle on a table, it is a hodgepodge of pieces. Once you get those corner pieces in place and the border set, however, the picture becomes much clearer. That's the way the indicators work.

Mutual Fund Indicators

Just as we pointed out at the beginning of this chapter, you can apply the Bullish Percent to any grouping of stocks, you can do the same thing to a universe of mutual funds. If you recall from Chapter 2, when plotting a mutual fund chart, we use three different scales for varying levels of sensitivity. Because of this fact, mutual fund Bullish Percents are maintained using three different sensitivity levels for each group. The short-term Bullish Percent reads the short-term charts for each fund using relatively small box sizes to pick up more net asset value (NAV) action and can be used by anyone who needs to take advantage of that short-term reading. The intermediate version is less sensitive and each fund is measured using its intermediate chart, which uses larger box sizes to filter out more NAV action, and this indicator can be used by all investors to gauge the bullish or bearish nature of the fund market. The long-term Bullish Percent reads the long-term charts, which use very large box sizes to filter out even more volatility and presents the long-term investor with something to give guidance on the major long-term areas of support and resistance for the fund. Figure 7.9 is a picture of the Intermediate Term All Equity Mutual Fund Bullish Percent.

The longer-term Bullish Percent is the less active of the three. All three Bullish Percent can still be useful and provide perspective in your analysis. I like to think about the varying nature of these Bullish Percents like a weather forecast. You can look at tomorrow's forecast or the seven-day forecast, or

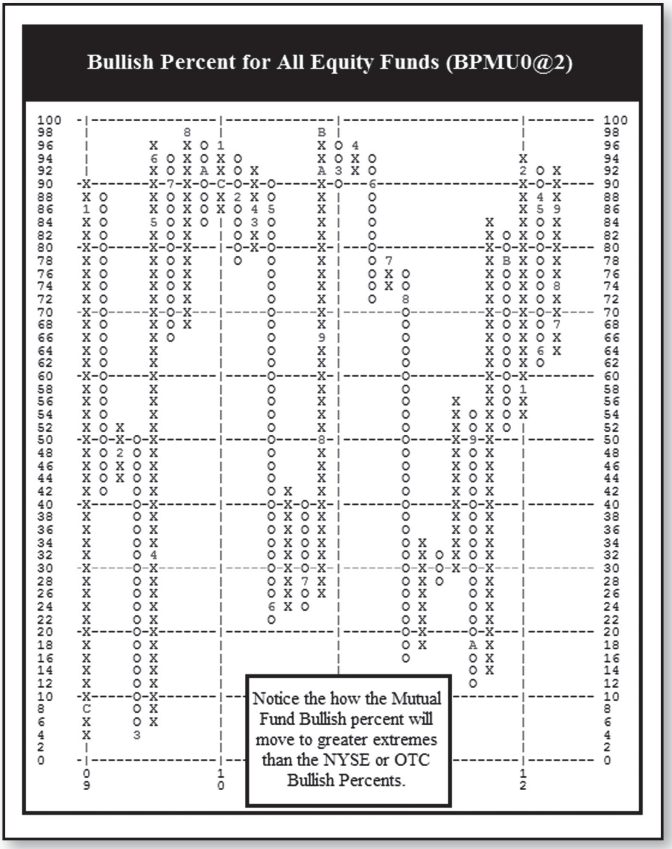


FIGURE 7.9 Mutual Fund Indicators: Intermediate Term All Equity Mutual Fund Bullish Percent

you can take a look at the entire season's projection for, say, rainfall. You will notice all of the same principles about Bullish Percents you have already learned to apply—X's mean offense and O's mean defense and that field position analysis is important. Something else you'll notice about mutual fund Bullish Percents is that they tend to move to greater extremes, often hitting 10 percent and 90 percent, especially the shorter-term Bullish Percents. Once you learn the application of the Bullish Percent concept, you can apply it to any universe—the S&P 500, mutual funds, or even foreign markets.

Other unique indicators in the mutual fund arena include additional moving average indicators. The 40-Week Bullish Percent is just like a 10-Week and 30-Week Bullish Percent, but this indicator measures the percent of funds in a group that have their NAV trading above their 40-week moving average, which is another way to say the 200-day moving average. Many

Intended Use	Symbol	Group	Type
Short-Term Analysis	BPMU0	All Equity Funds	BP - Short-Term
	TWMU0	All Equity Funds	10 Week
	MOMU0	All Equity Funds	Weekly Momentum
Intermediate Analysis	BPMU0@2	All Equity Funds	BP - Intermediate
	40MU0	All Equity Funds	40 Week
	30MU0	All Equity Funds	30 Week
Long-Term Analysis	BPMU0@3	All Equity Funds	BP Long-Term
	PTMU0	All Equity Funds	Positive Trend
	1040MU0	All Equity Funds	10 Week/40 Week

FIGURE 7.10 Mutual Fund Indicator Summary Table

technicians look at the 200-day moving average of the markets and individual equities, so it is a fairly important measurement of the health of price movement over time. It is helpful to know where this average is especially if the fund's trend line is too far away to be of immediate importance. The moving average is an invisible trend line that is always relevant, and you can use it to make trending evaluations.

Another longer-term moving average indicator for mutual funds is the 10/40 Bullish Percent. This measures the percent of funds that have their 10-week moving average above their 40-week moving average. Another way to look at this is whether the fund has its 50-day moving average above its 200-day moving average. If so, that would be considered a "buy signal" in the Bullish Percent calculation. Funds that have this characteristic are considered to be positively trending and vice versa.

At our web site (www.dorseywright.com), you can find the most extensive technical research available on mutual funds in the world. Figure 7.10 is a recap of the absolute mutual fund indicators followed on our web site, categorized by an investor's time frame. Those investors who are sensitive to the short-term fluctuations of the markets need to pay attention to the short-term indicators. Investors that have more of a buy-and-hold objective can use the long-term indicators to evaluate their funds and more tactically manage their portfolios. We tend to find the intermediate indicators to be the area of emphasis for us.

CHAPTER 8

Sector Rotation Tools

Sector Analysis with Bullish Percent Indexes

The same Bullish Percent concept that is applied to the New York Stock Exchange (NYSE), over-the-counter (OTC), mutual fund, and international markets can be applied to sectors within the market. In fact, on our web site we have created Bullish Percent indexes for every viable stock exchange in the world from Malaysia to Portugal. This application expands our ability to view the market as a whole as well as all of the individual pieces. The puzzle is the whole market, which is then broken down into individual puzzle pieces or sectors. Evaluating the individual pieces allows us to gain a sense of where each piece fits into the overall puzzle. Sector analysis is probably the most important consideration when investing. Sectors are like the schools of fish you might have seen on the Discovery Channel. These schools of fish dart quickly in one direction or the other, but what is amazing is how a whole school of fish moves perfectly together on each turn, as if some sixth sense tells each individual fish what the group is about to do. Sector rotation tends to behave the same way. Economic stimuli that would have an effect on a particular sector tend to have an effect on all the stocks underlying the sector, causing them to move in unison. Sector analysis is one of the most important yet least analyzed parts of the market. We place tremendous emphasis on sector rotation in our daily work. I have said in previous chapters that about 75 percent of the risk in a stock is associated with the market and sector, and only 25 percent

is stock-specific risk. Stocks don't just jump about without rhyme or reason. Moves tend to be orchestrated like the Boston Philharmonic.

Another analogy keeps coming to mind. I picture a herd of wildebeest romping across the African plains. They move in unison, first in one direction, then another. A few of the herd get out of sync, but the majority tends to move together. Those out of sync tend to get eaten as prey or they know something the herd does not. Sectors operate the same way. Wall Street tends to follow the actions of the herd. First, the sector's supply-and-demand relationship changes and more informed buyers begin to cause the stocks in that particular sector to rise in price. As the sector moves up, other institutions are alerted that the move is on, and they climb on board. Eventually, the mainstream financial media catch wind of a sector move under way and begin to write articles about how the industry has made a turnaround and should have clear sailing ahead. This draws in the individual investors just in time to catch the top. By the time the articles appear in magazines about how great the industry is, almost everyone is in who wants to be in, leaving little available demand to force the industry up much further. The last group in is the unsuspecting public, who use newspapers and magazines as their primary source of stock market research. *Time* magazine has a cover story about XYZ Company rated "Company of the Year." Mr. Jones, who sees this major statement on the cover of this mainstream magazine, calls his broker and buys the stock, virtually drying up the last available demand for the sector. Everyone is now in who wants to be in. The magazine cover signaled maximum saturation of positive information about this company. At this point, all it takes is the slightest selling pressure to start the downturn because there are no buyers left. With little demand left, it takes only a small amount of supply to turn the situation around. Once the public is in, virtually no one is left to do the buying. Remember that prices move as a direct result of supply-and-demand imbalances. If there are no more buyers left to cast their vote, supply, by definition, must take the upper hand. The sector then begins to lose sponsorship and moves to an oversold condition where everyone who wants to be out of the sector is out, and the whole process starts anew. It's actually beautiful how these natural rhythms evolve. When you think of the seasons changing, or the produce in the supermarket coming in and out of season, think of sector rotation as I do.

You know, I mentioned magazine covers. Watch them carefully. The next time you are in the airport, look at the magazine rack and see if you can find a widely read magazine that makes a major statement on its cover about some sector of the market—something like "The Banking Industry Is in

Trouble." If you find one, buy the magazine and keep it. Actually, just keep the cover. Normally, the trend in that sector will continue to move for a couple of months in the direction the cover suggests, as the last Joneses buy their shares. Give that sector eight months, and you will find its behavior has a high probability of being opposite of that suggested on the magazine cover. The reason for this is that the covers stirs Mr. Jones and Ms. Smith into action and while all the Joneses and Smiths are busy reacting, the sector moves in the forecasted direction. Once these investors are in and the supply-and-demand door slams behind them, there is no more buying or selling pressure (whichever the cover suggests) left to sponsor the sector. The forces of supply and demand slowly begin to change, optimism turns to pessimism or vice versa, and the sector takes the opposite tack. Try it—you will be amazed. It's simply human nature.

To put some quantitative research on why sector rotation is so important in stock selection, I want to discuss an interesting study we did at Dorsey, Wright & Associates (DWA). All investors have one thing in common, and that is their end goal. Everyone wants to make money, and preferably at a rate that will mitigate the effects of inflation and provide for a comfortable retirement. That means you need to be implementing an investment strategy that outperforms the S&P 500. Well, in all fairness, this may not have always been the case, but over the past decade it certainly stands true. There are many different methodologies that people employ to try to achieve this outperformance. Some turn to analyzing companies' financial statements and take a fundamental approach, some use quantitative methods, others may look to momentum or relative strength. Each have their pros and cons, and we have talked in past articles about applying these different strategies to the weighting methodologies for various exchange-traded products.

As we at DWA have said many times over, however, the real story is not whether one can consistently be effective at "market timing"—let's just chalk that up as a timeless debate—but instead the far greater tactical opportunity for advisers is that of sector rotation, and that is the real story. Many of you have built a successful business on the foundation of sector rotation; I hope you will find the updated graphics in this chapter useful for your endeavors. Others are looking to round out their case for bringing this aspect of portfolio management into their business, and to that end I'll help to make the case for sector rotation. I could spend all my effort dispelling the practice of buy-and-hold practices, strategic pie allocations, pure market timing, and the like, or I could just further the case for sector rotation, which is exactly what I'm going to do.

In constructing our first table, we started back in 1993 with $10,000. We then applied four different equity strategies: buy and hold, perfect market timing (each year), buying the best-performing sector (each year), and buying the worst-performing sector (each year). For the first two scenarios, we used the returns of the Standard & Poor's (S&P) 500; and for the sector timers we used the returns from the iShares Dow Jones sectors. Each of our four investors had different outcomes based on how they invested. Figure 8.1 simply shows the results, and in turn illustrates the opportunity afforded to those willing to seek strong sector themes and not just ideal market timing.

We'll call the first investor the "buy and holder." He just buys the S&P 500 and rides it up and rides it down, making no movements at all in the portfolio. Our second investor, with the benefit of hindsight, of course, is invested only during the years that the S&P 500 has an "up year." Our last

Market / Sector Timing Study: 1993 - 2011

Year End	Buy & Hold Strategy	Perfect Market Timing	Buying Best Performing Sector	Buying Worst Performing Sector
Beginning	**$10,000.00**	**$10,000.00**	**$10,000.00**	**$10,000.00**
1993	$10,706.00	$10,706.00	$12,414.70	$9,520.00
1994	$10,541.13	$11,162.08	$15,329.67	$8,357.61
1995	$14,136.71	$14,969.46	$23,721.13	$9,874.51
1996	$17,000.80	$18,002.27	$32,346.14	$9,879.06
1997	$22,272.75	$23,584.78	$48,176.34	$11,022.06
1998	$28,217.35	$29,879.55	$82,039.49	$10,110.54
1999	$33,722.55	$35,709.05	$150,690.13	$8,776.96
2000	$30,309.83	$37,819.46	$230,706.59	$4,810.65
2001	$26,354.40	$39,078.85	$231,560.20	$3,432.40
2002	$20,195.38	$39,696.29	$216,045.67	$2,074.89
2003	$25,522.92	$50,168.18	$324,997.50	$2,293.79
2004	$27,817.43	$54,678.29	$421,749.25	$2,286.22
2005	$28,651.95	$56,318.64	$562,529.15	$2,150.64
2006	$32,554.34	$63,989.24	$729,600.31	$2,252.58
2007	$33,703.51	$66,248.06	$981,166.49	$1,802.07
2008	$20,731.03	$67,129.16	$745,392.19	$866.25
2009	$25,592.46	$82,870.95	$1,213,945.71	$868.06
2010	$28,863.17	$93,461.86	$1,569,510.41	$889.15
2011	$28,862.31	$93,507.47	$1,797,874.18	$738.08
Avg. Annualized Returns	**5.74%**	**12.49%**	**31.42%**	**-12.82%**

Source: Market Performance based on S&P 500; Sector performance based on iShares Dow Jones Sector ETFs

FIGURE 8.1 Sector Analysis: Market/Sector Timing Study 1993 to 2011

two investors were sector investors, one of which was smart enough to know each and every year what the best performing sector was going to be for the year, and they invested 100 percent of their portfolio in that sector. The fourth investor was an unfortunate fellow who was perhaps just following a favorite magazine cover or something else that kept him on the wrong side of things each and every year as he managed to find the worst performing sector each year.

As you might imagine, each of the investors had dramatically different results from their initial investment of $10,000 back in 1993. Mrs. Buy and Hold currently shows a portfolio value of $28,862. Mr. Perfect Market Timer has a portfolio value of $ 93,507. But now for the "piece de resistance"—Ms. Perfect Sector Timer has seen her portfolio swell to $1,797,874 all while Mr. Poor Sector Timer's portfolio has now fallen to a lowly $738! Or, said another way, the average annualized return for the buy-and-hold strategy since 1993 has been 5.74 percent, it increases to 12.49 percent for perfect market timing, and is an astounding 31.42 percent for the best-performing sector. On the flip side, the average annualized return for the worst-performing sector portfolio is –12.82 percent.

The numbers for the best-performing sector are pretty astounding when we take into consideration 19 years' worth of data and include the dynamic bull market of the 1990s and the incredible returns of the technology sectors in the late 1990s. So what if we looked at just the past 12 years, since 2000. Would we see similar results? As you could guess, we have seen similar returns (Figure 8.2). During a period where the buy-and-hold strategy has you losing 1.29 percent per year of your portfolio, purchasing the one best sector every year shows a return of 22.95 percent on an average annualized basis.

While all these investors are fictitious, and certainly no one would ever be able to have the 100 percent accuracy that Mr. Market Timer and Mr. Good Sector Timer had, the study points out that market and sector timing are extremely important in investing. Being able to identify strong sectors and weak sectors enables you to gain an advantage over just buying and holding without regard for sector rotation. One doesn't even have to be close to getting every sector move correct to outperform the buy-and-hold theory.

When evaluating sectors, you must be a contrarian. You must find the courage to buy stocks in sectors that are out of favor. You must avoid the crowd. This is extremely difficult as it goes against human nature. We tend to gravitate to the crowd. You go to your neighborhood supermarket; it's payday and you are sure the store will be crowded. When you arrive at the

Market / Sector Timing Study: 2000 - 2011

Year End	Buy & Hold Strategy	Perfect Market Timing	Buying Best Performing Sector	Buying Worst Performing Sector
Beginning	**$10,000.00**	**$10,000.00**	**$10,000.00**	**$10,000.00**
2000	$8,988.00	$10,591.00	$15,310.00	$5,481.00
2001	$7,815.07	$10,943.68	$15,366.65	$3,910.69
2002	$5,988.69	$11,116.59	$14,337.08	$2,364.01
2003	$7,568.50	$14,049.15	$21,567.27	$2,613.42
2004	$8,248.91	$15,312.17	$27,987.85	$2,604.79
2005	$8,496.38	$15,771.53	$37,330.19	$2,450.33
2006	$9,653.58	$17,919.61	$48,417.26	$2,566.47
2007	$9,994.35	$18,552.18	$65,111.53	$2,053.18
2008	$6,147.53	$18,798.92	$49,465.23	$986.96
2009	$7,589.12	$23,207.27	$80,559.07	$989.02
2010	$8,559.01	$26,173.15	$104,154.83	$1,013.05
2011	$8,558.75	$26,185.93	$119,309.35	$840.93
Avg. Annualized Returns	**-1.29%**	**8.35%**	**22.95%**	**-18.64%**

Source: Market Performance based on S&P 500; Sector performance based on iShares Dow Jones Sector ETFs

FIGURE 8.2 Sector Analysis: Market/Sector Timing Study 2000 to 2011

store, you see that a major incident of sorts has captured everyone's attention. There is a major crowd around this incident. Do you go with the crowd to see what is happening or do you take advantage of an empty store while the other shoppers are crowded around the incident outside? The sector Bullish Percent indexes force you to go into the store and shop while you can with no interference. You will be able to have your pick of the best produce, best meats, not wait in line at the deli, and have first choice in the marked-down meat section. On top of that, you will be able to check out with no line, all because you went against the crowd. My curiosity would have had me go over to the crowd and see what all the fuss was about, as I'm sure your curiosity might have caused you to do; however, when investing, you must put your emotions aside and listen to what the supply-and-demand relationship of the market is telling you.

That contrary view of things is exactly what Earnest Staby was talking about in the mid-1940s. As mentioned earlier, trend charts always look most bullish at market tops and most bearish at market bottoms. The Bullish Percent indexes force you to be more negative at tops and more positive at bottoms. Once you see more than 70 percent of the stocks underlying the market or a sector go on buy signals, you are in a condition where just about

everyone is in who wants to be in. When translated into supply and demand, it simply suggests that the availability of demand has been spent. If this is the case, then an investor should be less enthusiastic about buying stock in the market or that sector when the Bullish Percent Index is at 70 percent or higher. When the index is near the 30 percent level or lower, it's time to put your buy list together.

When I was a stockbroker, I went with the crowd. It was easier to do business that way. Even though I was at a major brokerage firm with highly paid fundamental analysts who were literally hit or miss (you never knew which), my primary source of research was the *Wall Street Journal* and *Barron's* weekly financial newspaper. When those didn't yield enough ideas, I listened to the broker next to me pitching a stock. All of us got ideas the same way, and as you may have already guessed, the process was lackluster at best. Our training back then was basically in sales and not much else. It really hasn't changed much since then either. Now the emphasis for many stockbrokers is on raising money and giving it to a "professional manager" to manage, knowing full well that over 75 percent of all managers and mutual funds never outperform the broad averages. The broker's place in this equation is to manage the manager and manage the customer relationship for a fee. He primarily performs a middleman function. For the most part, computers perform this function as they do in most any other business. Somehow I seriously doubt this type of fee for the middleman function will rise in the future. Here's a serious problem I see for brokers going forward, at least the majority of the "Get Along Gang" of modern portfolio theory (MPT) brokers. Silicon Valley has initiated and all-out war on Wall Street, and most brokers I talk to on a daily basis aren't even aware of it. Right now, these technology investment management companies focus on MPT. This is all tech wiz kids in Silicon Valley can deal with. It's a simple computer program that you can get for free at Charles Schwab. These companies are beginning to make a dent, and the brokerage firms are not paying attention just like the brokerage firms didn't pay attention when Charles Schwab brought the first discount operation in 1974. We chose to look away and continue charging big fees and commissions. You see what has happened. Wall Street went bankrupt and Charles Schwab is still standing tall. The companies the brokers need to worry about are Wealthfront.com, Covestor.com, Sigfig.com, Betterment.com, Smart401k.com, Marketriders.com, and on and on. New sites come up every day and do a beautiful turnkey job of applying MPT in an investor's portfolio, and they do it for less than a quarter of the cost. They are here to stay, make no mistake about it. Financial planning is online,

too. Google "online financial planning" and you will have 222 million sites to choose from. This year, 2013, feels like we are living in the "Jetsons'" world. Think ahead five years and I'll bet Apple's Siri application is involved in your investments in some way. She might even be the person you talk to when you have questions about your account. Free up your mind to think in the future.

What is a broker to do? Most brokers have no plan of action one way or the other. Don't get me wrong, there are many craftsmen out there indeed, and many of them subscribe to the Point and Figure method of managing accounts. These people bring major value to the table. The investor's job is to find a broker who has a solid game plan that includes not only buy strategies but also sell strategies. I assure you, you will not find one by going to a branch office of any firm and asking for the broker of the day. Good stockbrokers who have all the skills to manage the money themselves are a rare breed these days. When you find one, stick with that broker. If you need one, just e-mail us (dwa@dorsey-wright.com), and we can suggest a craftsman who lives near your area. Most of our clients understand the concepts in this book and use them in their daily market operations. There are still no guarantees, but I assure you, I would want a broker who at least had the principles of this book firmly in mind. This is his operating system, just like Windows 7. There is no question about it—wealth is still created in the stock market. But as we found out in 2008 the market is also the fastest place to lose wealth if your portfolio is not managed properly. The year 2008 was a real eye-opener for most investors.

We run Bullish Percent calculations on numerous sectors as well as international sectors. International sector rotation is becoming increasingly more important as we shift to a totally global society. In Chapter 6, we discussed the NYSE Bullish Percent Index in detail. The same principles apply here. You might think these concepts are universally known, but they aren't. It's still a lost art, and it's 17 years from my first edition of this book. There used to be a TV show called *The Street*. I was totally surprised that on the show they shouted over the broker's intercom, "The Point and Figure Charts are now updated." It really floored me when I heard this. How did Hollywood ever learn about the Point and Figure concept and feel it was important enough to create an audio that all the viewers of the program could hear? I was so surprised because very few individuals or professionals understand these concepts. After reading this book, you will join a very elite group of investors I often call The SEAL

Team 1 of Wall Street. This is the only technical analysis book the legendary investor Jim Rogers has ever endorsed. You would be hard-pressed to find a broker, outside our client list, who understands this philosophy and has reached what we would call craftsman status. The reason is simple: it takes some education and dedication to understand it, and most investors and professionals are not interested in going that extra mile to become a true craftsman. A good friend of mine, Dave Winder, is a master plumber. He told me it takes more than four years to become a craftsman plumber, much less a master. Why would the business of investing take any less time? Those of you who are reading this book are a rare breed indeed. You are learning a lost art.

Everything you learned in Chapter 6 on the Bullish Percent Index applies here, so I'm not going to rehash the discussion. If you find you do not understand this concept thoroughly, go back to Chapter 6 and reread it. Sectors employ the same concept, but the number of stocks in the sector universe is smaller than that of the NYSE or Nasdaq universe. Because of the smaller number of stocks in sector Bullish Percents, they tend to move faster than the NYSE Bullish Percent. To construct a statistically valid Bullish Percent, a sector should have a minimum of 100 stocks. If you have less than 100 stocks, then one stock's buy or sell signal could move the Bullish Percent more than 6 percent. The best way to get a handle on using this concept as well as other indicators for sectors is to take an example and go through it. Let's take a look at a sector Bullish Percent chart and outline on the chart where the pertinent changes took place.

Electric Utility Bullish Percent

In Figure 8.3, you can see the Electric Utility Bullish Percent. Many people would regard this as a sleepy sector, not worthy of consideration because "it doesn't move enough." That really is not the case at all. This sector, like others, has provided good opportunities over the years and as of this writing, the Bullish Percent for electric utilities currently resides at the 70 percent mark, after having bottomed at 4 percent in October 2008. That's a good run for what is considered a category of high-yield stocks. In 2012, the most sought after stocks were dividend stocks. I have owned utilities for many years. In fact, I buy Dominion Resources each time we pay our electric bill. I'll bet you didn't know your local utility company allows you to buy stock on your monthly bill. It's a great way to save. I have

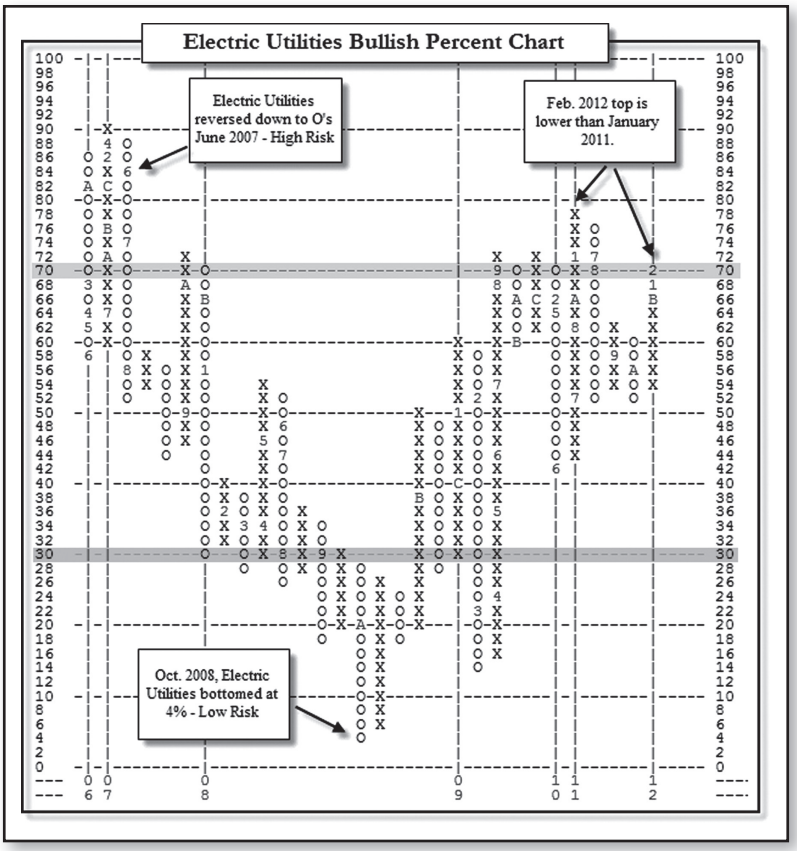


FIGURE 8.3 Sector Bullish Percent Charts: Electric Utility Bullish Percent

done this for years and now have a substantial amount of stock simply by buying monthly. I also buy it in bulk on the exchange. I just like this stock and it's in my own backyard. When I retire and draw on my investments to live, this will be a big help.

On the Bullish Percent chart of electric utilities notice the long drop it had from the top in 2007 to the bottom of the meltdown in 2008. In April 2007, the indicator was at 90 percent telling us that 90 percent of the stocks within the Electric Utilities sector were trading on Point and Figure buy signals. This was a "high-risk" time, as indicated by a reading above 70 percent. It told us that all the people who wanted to be in this sector were already in. By the end of October 2008, this indicator had bottomed at 4 percent. That move from June 2007 to the October 2008 lows saw the PHLX Utility Index (UTY) fall 35 percent. Since its bottom in 2008, well below the 30 percent start to the "green zone" or "oversold" territory on its Bullish Percent chart,

it has made its way back up the chart. The electric utilities sector steadily picked up buy signals, and is now trading at 70 percent in August 2012. However, notice the lower top in February of 2012 in relation to the peak at 78 percent in January 2011. Could investor demand for typically high-yield utility stocks be declining? Could we be nearing a point where interest rates will rise? Maybe, but that is the benefit of evaluating indicators like the Electric Utilities Bullish Percent Index, and other Bullish Percent indexes for that matter. When these indicators change, it will force us to change. We do not have to listen to market pundits or the so-called experts to try and anticipate the next move. Utility stocks are typically higher-yielding names, and if at some point down the road interest rates rise, investors conceivably are then able to access higher income through the fixed-income market, which causes them to sell utility stocks. This may come in the next six months or it may come six years from now.

Sector Bell Curve

The sector bell curve is one tool we use to get a good perspective of the overall market's relative position on a normal distribution. You probably know this as a bell curve. There are basically just two things we know from the study of economics or statistics that we can apply to the stock market. First, supply and demand governs all price change. Embrace it! When there is more demand than supply, the price will rise and conversely when there is more supply than demand prices will fall. We depict the supply and demand in the marketplace by recording the price (the net of all supply and demand) of a stock in a logical, sensible, and organized manner, the Point and Figure chart. Second, we have the statistical concept of the bell curve with an overbought, oversold, and normal level.

What is really interesting about this curve is it's not really a normal distribution at all. We just thought one day that it might provide some insight for us if we laid out the Bullish Percent readings for all sectors on a bell curve. It proved to be very illuminating and provided us great perspective on the relative overbought or oversold nature of the market. This is a concept you will never learn in a university. For that matter, you will never learn any of the concepts in this book at a university. Now read carefully: every sector will always trade between 0 percent and 100 percent because every stock in the sector can either be on a buy signal (100 percent), on a sell signal (0 percent), or somewhere in between. Typically, we publish the sector Bullish Percent readings in a vertical format with the Y-axis

on the left going from 0 percent to 100 percent like that of the Electric Utility Bullish Percent in Figure 8.3. With the sector bell curve, we take the vertical axis and make it the horizontal axis. Then, the first four letters of each sector Bullish Percent (for ease of identity) are plotted on the curve. If the sector abbreviation is in upper case, then the sector Bullish Percent chart in question is in X's on its own Bullish Percent Index, and moving to the right of the curve. Lower case letters indicate the sector Bullish Percent is in O's and moving to the left of the curve. Plotting each of the sectors on a bell curve in this fashion gives us a composite picture of the risk in the market. Sometimes, as in October 2009, the curve will get skewed to the right-hand side indicating an overbought market. Exactly one year earlier in October 2008 the curve was skewed to the left hand side or the oversold side of the ledger. When you see a bell curve like that pictured in Figure 8.4, it usually suggests a market that has bottomed. I have said many times on *Fox Business* shows that when you get a sector bell curve that is skewed to the left my guess was the market would be much higher several months down the road simply because we had a picture just like what you see in Figure 8.4.

Sometimes, like October 2009, the bell curve will get skewed to the right-hand side of the ledger suggesting an overbought market (Figure 8.5). Pictures like this don't happen very often, only once every couple of years on average. Most of the time, a correction will take the bell curve from an overbought position down to what I call a normal market were most of the sectors are huddled around the middle of the curve. This is where the market resides about 68 percent of the time. This further suggests that the right strategy 68 percent of the time is a neutral strategy or covered write. To get a very interesting visual of how the market moves, go to our Database Tab at www.dorseywright.com and click on Sector Bell Curve. The first picture that you come to will provide a current snapshot of the sector bell curve; however, from this page you also have the ability to view the sector bell curve from any specified date in the past, like the two mentioned earlier. You also have the ability to compare the sector bell curve picture of two dates by entering a date in the "Compare To" field. Once you compare two dates, you will see an animate button you can click, which will automatically scroll through the sector bell curves between those dates. It's amazing to watch the market move back and forth on that scale. It really points out how you have a clear advantage buying when the market is oversold and protecting your assets when it is overbought.

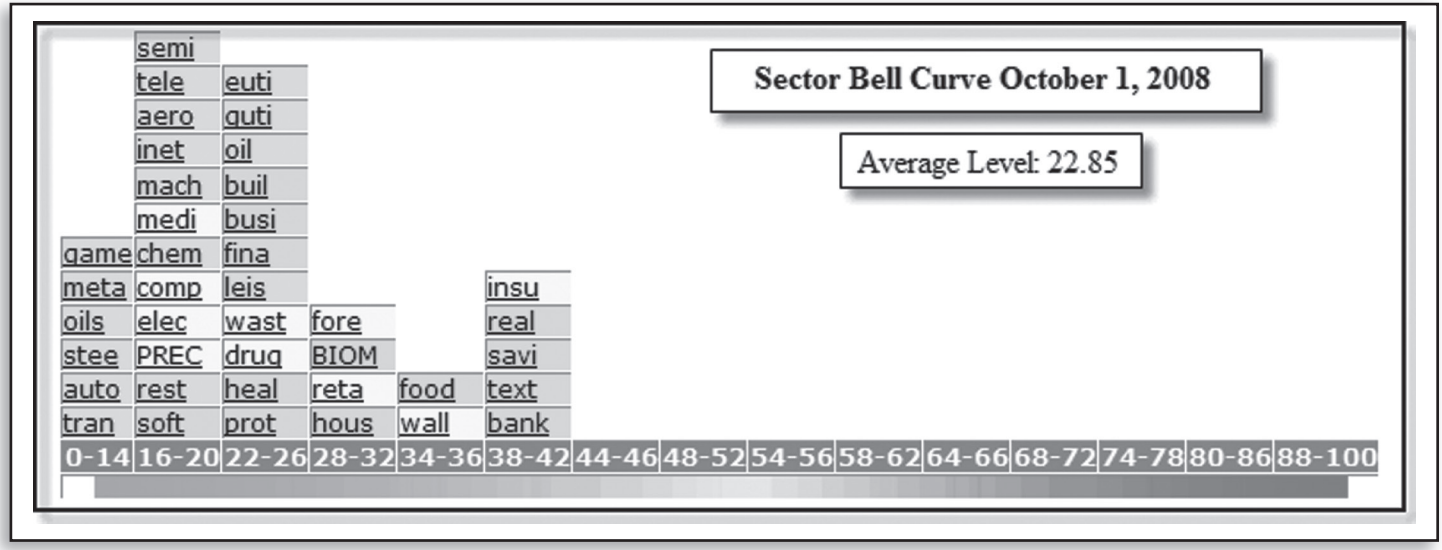


FIGURE 8.4 Sector Bell Curve, October 2008

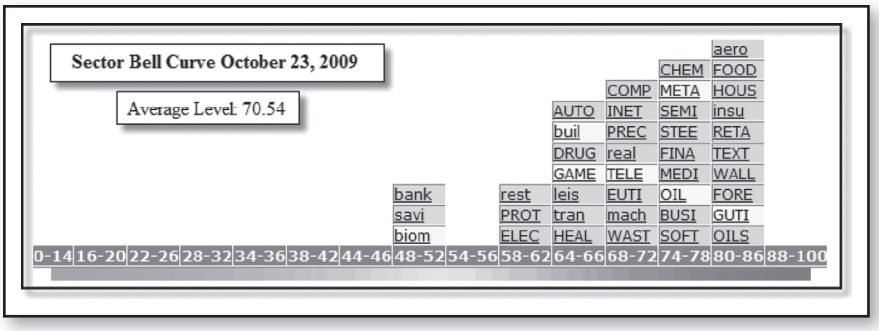


FIGURE 8.5 Sector Bell Curve October 2009

Favored Sector Status

Now, let's bring another piece of the puzzle into the equation—relative strength (RS). As you read in Chapter 4 and 5, RS is an integral part of our work. Starting in the mid-1990s we began to take a much closer look at incorporating an RS overlay to the Bullish Percent work and here's the reason. We might have two Bullish Percent charts that looked almost identical. Both had corrected from overbought territory above the 70 percent mark down to oversold territory below the 30 percent level and reversed up to X's. Positions were taken in both sectors and one vastly outperformed the other. A look at the sector bell curve of October 2008 in Figure 8.4 shows that Precious Metals (PREC), Healthcare (HEAL), and Electronics (ELEC) all were down into oversold territory, and by the end of October 2008 and had reversed into X's signifying they were on the move up with field position. A look at performance one year later, to the end of October 2009, shows that all three sectors performed well, but precious metals had the best returns of the three, up 113 percent while Healthcare was up 21 percent and Electronics up 48 percent (Figure 8.6).

FIGURE 8.6 **Favored Sector Status Performance October 2008 to October 2009**

Sector	Performance October 1, 2008 to October 31, 2009 (%)
DWA Precious Metals Sector	113
DWA Healthcare Sector	21
DWA Electronics Sector	48
S&P 500 Equal Weight Index	21
S&P 500 Index	7

From a portfolio management perspective, how could we better ascertain the potential magnitude of movement from sectors? We've found RS to be an invaluable tool, specifically the favored status ranking.

The concept behind the favored status ranking is to marry RS readings with the Bullish Percent concept we know works so well. We began keeping the charts that comprise favored status in 1997, so these charts now have some longevity to them. Let's think back for a second about an individual stock evaluation. If I were thinking about buying a stock, some of the basic things I would want to see are that first the stock was trading in a positive trend or on I-95 North. Next, I would want to see that the stock had good RS versus the market long term and short term. It would make sense then that if these are general attributes of a stock I would want to buy that before I invested in a particular sector of the market, I would want to focus on those sectors where more stocks were moving to positive trends and showing good RS versus the market. This is the genesis of the indicators we use to determine favored status ranking. Each ranking alone is a valuable tool but the favored status ranking really gives life to these individual indicators. Figure 8.7 shows the four criteria we use to assign a favored status ranking for sectors.

Let's now take a more detailed look at each of the four criteria used to determine favored status ranking.

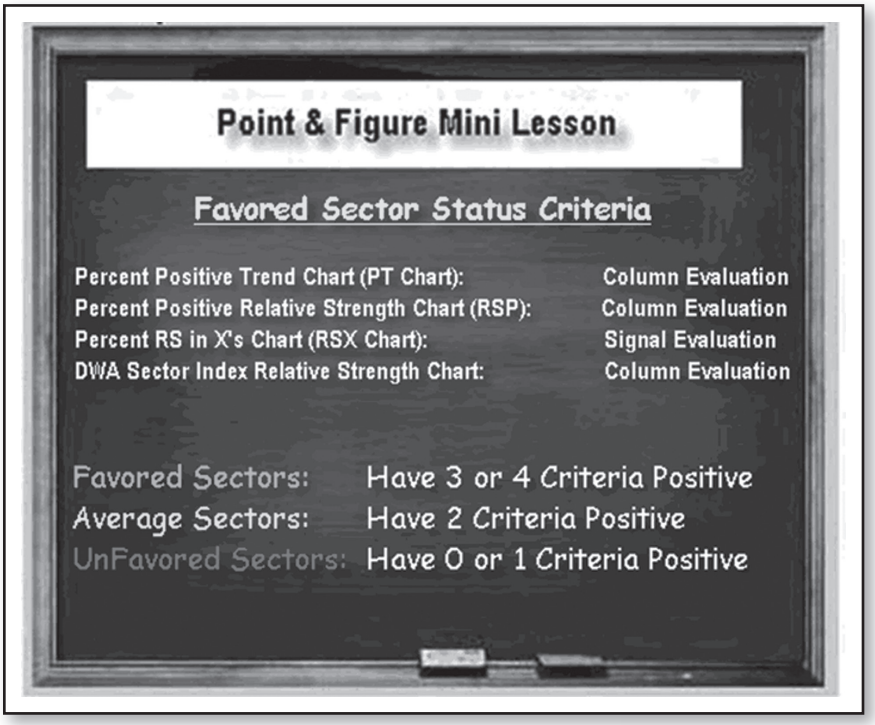


FIGURE 8.7 Favored Sector Status Criteria

Sector Relative Strength

In Chapter 5, you learned about sector RS. Specifically, for each DWA sector an equal weighted index is created. Just like a stock, a daily RS calculation is performed and then plotted on a Point and Figure chart. To quickly review, the daily RS calculation is the price of the sector index divided by the S&P 500 Equal Weighted Index and then multiplied by 100 to provide a reading. The reading is then plotted on a Point and Figure chart. When the Sector RS chart is in X's, we can assume that group has a higher probability of outperforming the market than underperforming the market and vice versa. We will be well rewarded for focusing our investments in those sectors whose RS charts are in X's. If you're not completely comfortable with the RS concepts, go back to Chapters 4 and 5. Before you can fully grasp how we apply RS to sectors, you need to be comfortable with how individual equity RS is calculated. It's like learning anything else; you probably won't get it all on the first reading. Utilize the exercises, review the concepts, and pull up some examples on your own at our web site. This will take you miles into your journey of becoming a craftsman.

Percent Positive Trend Chart

The Percent Positive Trend (PT) chart measures the percent of stocks within a particular market or sector trading above their bullish support lines. So let's say there are 100 stocks in a sector and 50 of them are trading above their Bullish Support Lines. This would give us a reading of 50 percent. If this number is increasing, it tells us more stocks in the sector are turning to positive trends and supporting higher prices. Conversely, if we see a net 6 percent change of stocks that were in positive trends now in negative trends, it would cause the PT chart for that sector to reverse down suggesting the trends of stocks in this sector are turning negative. It is this battle between the two trends that eventually causes one or the other to win the match and reverse. It is the reversal (a column of X's or O's) on the PT for the sector that warrants our attention.

As outlined earlier, whenever we initiate a new position, we try to stack as many odds as possible in our favor and one of the primary things we look at is "what is the overall trend of the stock?" We want to focus our buying on those stocks trading above their bullish support line. In the aggregate, we want to focus on those areas of the market that are showing more and more stocks moving to a positive trend or trading above their bullish support line. We can easily see whether this is happening by looking to the PT chart of an overall market or a sector. Like a Bullish Percent chart, if this chart is in X's we say it is positive and if this chart is in O's, we say it is negative.

Percent Relative Strength in X's

Another important attribute we want to see in any stock we purchase is that the RS chart is in a column of X's, showing the stock is currently outperforming the market. Taking the same logic of the PT charts, we want to focus on those areas of the market that are showing more and more stocks in a column of X's on their RS charts. Within each industry group, we calculate the number of stocks whose individual RS charts are outperforming the market on a shorter-term basis. Though RS signals on average last two years or more, a change in columns on the RS chart can last several months, and we find it very useful to evaluate stocks based on their RS chart's most recent column. If the RS chart is in X's the stock is outperforming on a nearer-term basis; if it is in O's, it is underperforming the market on a nearer-term basis.

This Percent of Stocks Whose RS is in X's (RSX) percentage is also plotted on a grid from 0 percent to 100 percent, like the PT indexes, and when this indicator is in X's and moving higher, it suggests that area of the market or sector is performing better than the market on a shorter term basis. We refer to these charts in-house as RSX charts because we use the prefix RSX before the market or sector symbol to call up the chart on our web site. For example, RSXTELE is the percent of stocks in the Telecommunications sector that have their RS charts in a column of X's. When evaluating the RSX chart, because it can move the fastest of all the favored status indicators, we look at the *signal* on the chart. We place the most emphasis not on what column the chart is in but, rather, whether it is on a buy or a sell signal, a double top or a double bottom.

Percent Relative Strength on Buy Signals

The Point and Figure RS buy and sell signals are long term in nature, lasting on average two years. Within a market or an industry group, we calculate the percentage of stocks whose RS charts are on buy signals. This percentage is then plotted on a grid from 0 percent to 100 percent. When it is in a column of X's and rising, it means more stocks underlying that sector are getting stronger versus the market on a long-term basis. This indicator is much slower moving than the Percent RS in X's and the PT. When changes in the Percent RS on Buy Signals (RSP charts) do occur, however, they are important. For instance, the Percent RS on Buy Signals for the OTC Market (RSPOTC) chart made a high September 2003 at 72 percent, and it has not been near that level since. February 2012 this index reversed up but has not been able to gain any sponsorship since then and it's now August 2012 and the indicator continues to reside at the 40 percent level. When a sector's RSP chart reverses, for instance, into a column of X's that is telling us that

6 percent of the stocks in that sector have gone from a RS sell signal to a RS buy signal and the tide has shifted from these stocks underperforming the market to these stocks outperforming the market. Since the average RS signal lasts about two years, reversals on these charts are major statements about a sector's likely future performance. There is one big caveat: if the overall market is not willing to support higher prices, it's going to be a tough road for all stocks. Since this is an RS-based indicator, remember we are measuring relative performance, not absolute performance. The most important part of the RSP chart is whether it is in a column of X's or O's. Let's quickly summarize again the indicators that go into determining a sector's favored status. The following are the four indicators we use to evaluate sectors on a RS basis:

1. Sector RS chart: Look at the column.
2. Sector Percent Positive RS (RSP) chart: Look at the column.
3. Sector Percent RS Chart in X's (RSX) chart: Look at the signal (buy or sell).
4. Sector Percent Positive Trend (PT) chart: Look at the column.

For each sector, we evaluate each of these indicators and give the sector a rating of 0 to 4. If all four of the indicators were positive, the sector would get a score of 4. If none of the indicators were positive, that is, all of the charts were in O's or on a sell signal in the case of the RSX chart, then the favored status score would be 0. When the majority of these indicators are positive, that sector should be a market leader and it is where we would concentrate most of our new money going into the market. Once the sector no longer has the majority of indicators in its favor, then we must begin to think about defensive strategies. New positions in sectors where the majority of indicators are not positive suggest we should expect trading rallies or short-term trading moves only, not market leadership qualities. Once we have established the score, we then assign the sector a favored status according to the following template:

Favored sector: 3 or 4 indicators positive
Average sector: 2 of the indicators positive
Unfavored sector: 0 or 1 of the indicators positive

I think the concept of favored sector will come alive with an actual example. We'll start with the Building sector from January 2012. Let's look at the four charts that make favored sector status in Figure 8.8 and just count off what is positive. The first chart is the DWA Building Index (DWABUIL) RS chart. Notice that this chart is in a column of O's, so we cannot count that one as a positive. After looking at one of the four charts that comprise the favored sector status,

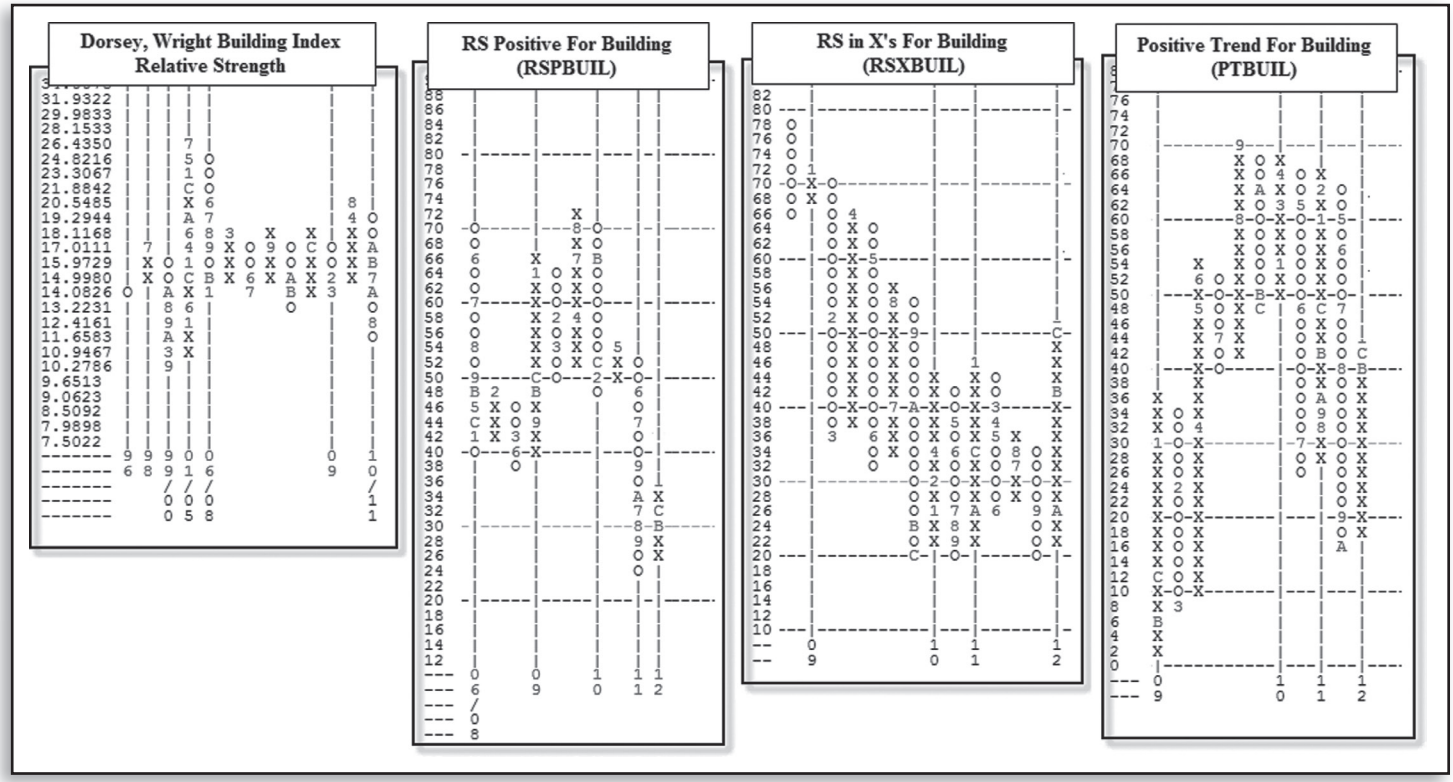


FIGURE 8.8 Favored Sector Status: Building Sector Charts

our score is still 0 out of 4. Next, we can take a look at the Percent Positive RS for Building (RSPBUIL). This chart is in a column of X's, having reversed up in November 2011, so we have a positive for the group and our score is now 1 positive score for the sector. Moving on, the Percent RS charts in X's for Building (RSXBUIL) is on a buy signal. Remember that the buy signal is a column of X's that exceeds the previous column of X's. The chart will remain on a buy signal until a column of O's exceeds the previous column of O's (a sell signal). In this case, the last signal was in fact a buy so we have another positive for the group. Our favored score is now up to 2 for the sector. The final chart to evaluate is the Percent Positive Trend for Building (PTBUIL). This chart is also in X's so we add another positive to the score and we can say that the Building sector has 3 out of 4 of its favored sector status indicators positive and is thus a favored sector.

What this tells us is that the building sector has a higher probability of being an outperforming sector of the market than a sector with an unfavored sector status, like the Precious Metals sector. From the same time, January 2012, here's how the favored sector status charts for the Precious Metals sector stacked up:

Precious Metals Relative Strength chart	Column of O's
Precious Metals Positive Relative Strength chart	Column of O's
Precious Metals Relative Strength chart in X's	Sell signal
Precious Metals Positive Trend	Column of O's

If we count up the score for the Precious Metals sector, we come up with 0 out of 4 positive and that makes the Precious Metals sector an unfavored group. In January 2012, both the Building and Precious Metals sectors were in a column of X's on their Bullish Percent charts but a further investigation into the groups, another overlay of analysis if you will, and we see that Building is a favored sector and Precious Metals is an unfavored sector. Which are you going to overweight? The favored sector, of course. And it pays off. From January 1, 2012, through August 31, 2012, the Precious Metals sector is up 4 percent, while the Building sector is up 38 percent!

Figure 8.9 provides an example of how we show the favored sectors on our web site. Keep in mind that uppercase letters signify that the Bullish Percent for that sector is in X's. Lowercase letters signify the Bullish Percent for that sector is in O's. Notice at the top of the chart that we have favored sectors for DWA groups, Broad groups, sectors, subsectors, and mini sectors.

We knew intuitively at DWA that the favored status work added a tremendously important tool to our analysis, but we wanted to put some actual numbers to this work so we went to work on a comprehensive analysis of the favored sector status. The results were quite astounding and confirmed something we had already seen work so many times for us in the past.

DWA Groups | Broad Groups | Sectors | SubSectors | MiniSectors

Bullish Percent Chart Levels	BP Level	Favored 4	Favored 3	Average 2	UnFavored 1	UnFavored 0	BP Level
	0 to 30 Xs						0 to 30 Xs
	32 to 68 Xs	PREC 52.00%	BIOM 48.00% SOFT 54.00% HEAL 58.00% AUTO 60.00% RETA 60.00% FOOD 62.00% MEDI 62.00% CHEM 66.00% MACH 66.00% BUIL 68.00% FORE 68.00% TEXT 68.00%	META 38.00% SEMI 40.00% COMP 44.00% TELE 44.00% DRUG 50.00% INET 50.00% STEE 52.00% LEIS 56.00% REST 58.00% FINA 62.00%	ELEC 32.00% WAST 46.00% PROT 48.00% OIL 54.00% AERO 56.00% OILS 60.00% GUTI 64.00%	GAME 38.00% TRAN 44.00% BUSI 54.00%	32 to 68 Xs
	70 to 100 Xs	EUTI 70.00% HOUS 72.00% INSU 72.00% REAL 74.00%	BANK 70.00% SAVI 72.00%	WALL 70.00%			70 to 100 Xs
	0 to 30 Os						0 to 30 Os
	32 to 68 Os						32 to 68 Os
	70 to 100 Os						70 to 100 Os
	BP Level	4	3	2	1	0	BP Level

FIGURE 8.9 Favored Sector Status: Dorsey Wright Web Site

In the study, each of the 40 DWA sectors was considered. We update this each quarter. In Figure 8.10, you will see the most recent update following the second quarter of 2012.

Now that we have reviewed what favored status is and how it is achieved, we want to add some validity to this concept, which we can accomplish through an update to one of our studies, which simply uses the equal-weighted DWA tracking index for each of our 40 sectors as the investment proxy for each sector. Sectors are "bought" whenever they achieve favored status, and they are held until they fall to unfavored status. Each sector index is equal weighted within the hypothetical portfolio and the portfolio is rebalanced upon any change. Once a sector makes its way into the portfolio it is given the freedom to fall into "average" status, and move back to favored, but a trip to unfavored status causes removal from the portfolio. With those rules in place, we have created two indexes on the DWA databases, one that tracks favored sectors based on that rules set, and another that tracks "all of the rest," or unfavored sectors.

DWA Favored Sector Tracking Indexes

- DWA Favored Sectors Index [FAVSECTOR]
- DWA UnFavored Sectors Index [UNFAVSECTOR]

Favored Sector Portfolio Test

FAVSECTOR represents an equal-weighted portfolio that is rebalanced upon changes comprised entirely of DWA sector indexes representing groups that have more recently attained "Favored Status" than "Unfavored Status". UNFAVSECTOR is a similar portfolio, populated by all DWA Sector Indices not qualifying for FAVSECTOR.

	Favored Sectors (FAVSECTOR)	UnFavored Sectors (UNFAVSECTOR)	+/-	RSP
2012*	**6.71%**	**5.43%**	**1.28%**	**7.00%**
2011	-2.58%	-9.08%	6.50%	-2.18%
2010	24.86%	26.05%	-1.19%	19.68%
2009	58.31%	40.29%	18.02%	42.19%
2008	-40.88%	-39.60%	-1.28%	-41.08%
2007	7.52%	-8.17%	15.69%	-0.34%
2006	13.99%	20.00%	-6.01%	14.12%
2005	0.99%	0.43%	0.56%	6.26%
2004	25.55%	18.99%	6.56%	15.29%
2003	48.89%	41.94%	6.95%	38.89%
2002	-8.32%	-19.41%	11.09%	-19.43%
2001	2.51%	13.69%	-11.18%	-1.85%
2000	14.48%	-9.35%	23.83%	7.63%
Cumlative	202.42%	58.94%	89.07%	72.85%
Avg. Ann.	**11.78%**	**7.91%**	**8.86%**	**8.36%**

Performance as of 6/30/12, not inclusive of dividends, fees or expenses

FIGURE 8.10 Favored Sectors: Favored Sector Portfolio Test

As you might imagine, the number of holdings in each index can fluctuate substantially based on the breadth of the current market—they both can and do. For instance, there were just 14 sectors that had made their way back into the FAVSECTOR index at the end of 2011. As such, the UNFAVSECTOR index has seen its constituency shrink from 26 holdings at the beginning of the 2011 to 16 towards the end of the year. Keep in mind that this rotation into the FAVSECTOR index has been mainly a function of a strong first quarter 2012 combined with stagnation across most sectors throughout Q2. The graphic in Figure 8.11 takes into account year-to-date returns (through June 30, 2012), but, more important, demonstrates the value added of implementing this type of strategy over a long investment time frame.

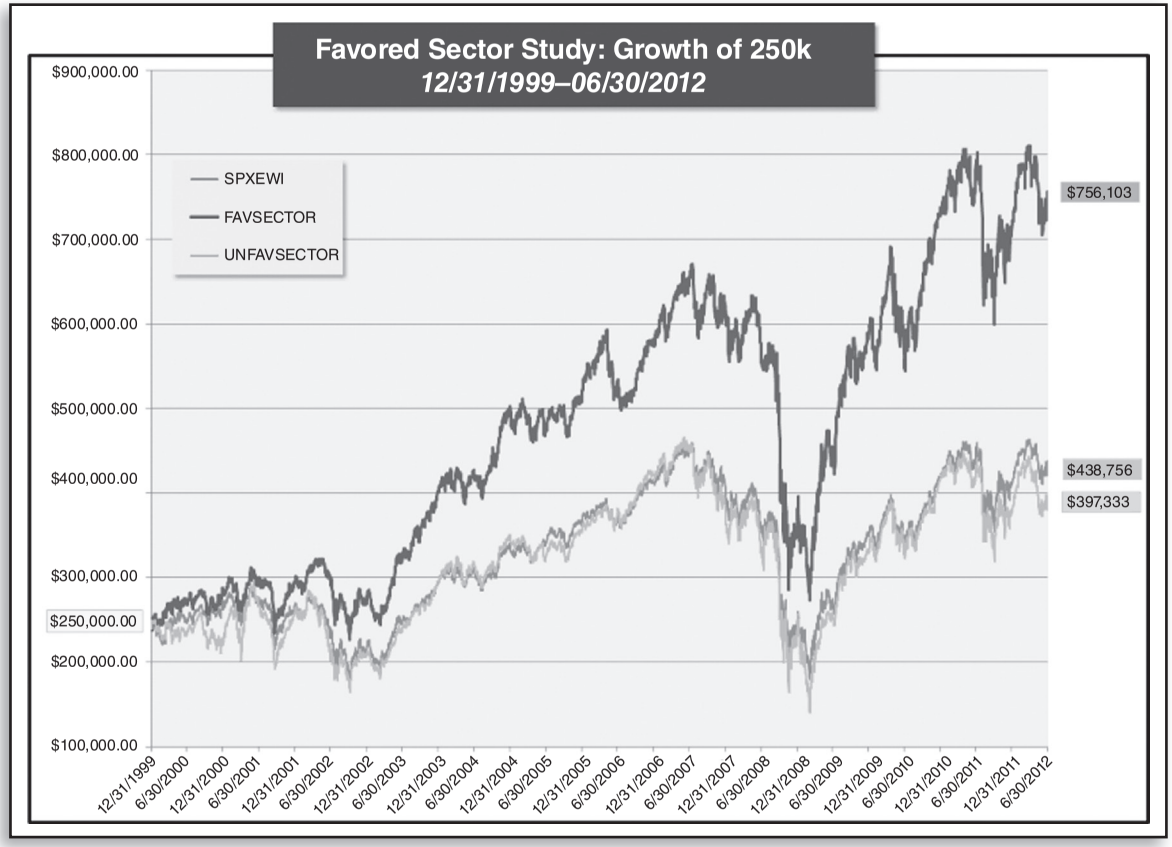


FIGURE 8.11 Favored Sectors: Favored Sector Study

Summary

At this point in the book, I imagine your mind is racing with ideas of how this methodology can be incorporated into your current investment process. As we have pointed out before, this methodology is an operating system similar to Windows 7 that allows your computer to run programs. The great thing about the methodology is that once you have the operating system, the choice of which programs and what you want to accomplish on the computer is up to you. Throughout this chapter, I hope that you've learned the processes that can be applied to a variety of different investment styles, from Trader to long-term Buy and Holder, to increase your odds of success, and that's all we can ask of ourselves in the market—stack as many odds in our favor as possible and then manage the position.

"The Art of Winning"—How Failure Teaches Us

Excerpt from* the Daily Equity and Market Analysis Report by *Judd Biasiotto PhD* and *Tom Dorsey

The story of Thomas Edison's life is a prime example of the American Dream. Without question, he was a giant among men. He saw light when others saw darkness. During his lifetime he patented a record 1,093 inventions. His inventions literally revolutionized the world. He was truly one of the greatest minds in history. Like all men, however, Edison knew failure. In fact, he failed quite a bit. But like all great men, Edison looked at failure as a learning experience. An experience that would help him grow and develop. His son Charles Edison wrote about his father: "It is sometimes asked, didn't he ever fail? The answer is yes." Thomas Edison knew failure frequently. His first patent, when he was all but penniless, was for an electric vote-recorder, but maneuver-minded legislators refused to buy it. Once he had his entire fortune tied up in machinery for a magnetic separation device for low-grade iron ore only to have it made obsolete and uneconomic by the opening of the rich Mesabi Range. But he never hesitated out of fear of failure. "Shucks," he told a discouraged co-worker during one trying series of experiments. "We haven't failed. We now know a thousand things that won't work, so we're that much closer to finding what will."

I had to fail many times as a broker to finally find my way. I didn't know how to become excellent at this business. I always thought the key was simply doing what my wonderful firm told me to do and if I lost money for a client it was the analysts' fault. It wasn't until I was given the opportunity and responsibility to develop and manage Wheat First Securities first Options Strategy Department that I came to the realization that the key to success resided within me and nowhere else. I had to become the one responsible for

my recommendations and research and no one else. There was no passing the buck, the buck stopped with me. It's amazing how fast you find your way when you finally accept that success or failure is on your own shoulders and no one else's. That is the point when the Point and Figure Method came to light for me. Before that, I found every way one could fail in this business, and some ways you can't imagine, I found them. I never failed at the production side of the equation but I did when it came to profitability of my clients. When I accepted responsibility for my success or failure, the path changed and I began to experience far more success than failure.

Following a fire which destroyed his whole laboratory, Edison said, "You can always make capital out of disaster. We've just cleaned out a bunch of old rubbish. We'll build bigger and better on the ruins." It's obvious that Edison's setbacks were not viewed by him as a hindrance. Have you lost money for clients and failed to learn from that mistake or have you taken the time to evaluate just what went wrong and took steps to correct it? If you learn from your mistakes, you become a much better broker. If you blame the fundamental analyst for the stock going down, you are not taking responsibility. Conversely, if the stock does well, it's also your call.

"At 5:30 the next morning, with the fire barely under control, he called his employees together and announced he was rebuilding. One man was told to lease all the machine shops in the area; another, to obtain a wrecking crane from the Erie Railroad. Then, 'Oh by the way. Anybody know where we can get some money?'" Do you need to rebuild the relationships that might have been lost riding this last decline in the market down? Are you going to simply begin another year on the wrong foot? Maybe there is nothing that needs to be done, but if there is, get on it now!

Failure teaches us. Or, to quote Ben Franklin, "Those things that hurt, instruct." If we get burned, we learn not to play with matches. If we make a mistake, we learn not to do it again. Nobody can avoid failure all the time, especially in the brokerage business. It's a part of our life. It's how we deal with the failure we ultimately must face from time to time in this business that determines how good you will be as a broker. If you continue to make the same mistakes over and over again, you are doomed to ultimate failure. This is why it is always important to actually write down why you buy a particular stock. If it turns out to be the wrong decision you can easily go back and evaluate just what went wrong. As you learn from your mistakes your confidence will rise. Losing is more instructive and informational than winning. For instance, research has revealed that athletes have a greater tendency to analyze their performances when they lose than when they win. Of course, when an athlete's performance is analyzed, mistakes are brought to the forefront to be examined and corrected. Terry Bradshaw, two-time Super Bowl MVP and Hall of Famer of the Pittsburgh Steelers, once said, "Failure is the most critical element to success. I don't know of a single athlete who's achieved greatness who hasn't tasted defeat. Until you're beaten, victory has no meaning."

If your stock picks or portfolio management results fall short of success, don't blame others. Take full responsibility for your behavior. A person who takes total responsibility for his shortcomings is usually admired. Don't just accept your mistakes though, learn from them. Analyze why you failed. I never did this when I was a broker. Analyze why you failed in your investment performance. Determine what you've done wrong, then go about making adjustments to enhance your performance. Remember, success is simply the manipulation of error. Also, remember that everyone fails in this business of investing at some point or another. It's part of being human. I have talked to many brokers who just couldn't get it right. They were on the verge of getting out of the business until they analyzed what was going wrong in their stock management process and finally got it right. In many cases it's simply beginning to embrace technical analysis along with their already good fundamental research. Stop, think, evaluate, and make adjustments. You can be great. And above all rejoice in your "humanness"!

PART II

The Point and Figure Methodology—A Complete Analysis Tool

CHAPTER 9

Fixed-Income Indicators

One of the most important themes in the market to keep close track of is the fixed-income area. At this stage in my life, it plays a major part in my investment strategy. Don't get me wrong—I haven't turned chicken, and I do not believe the college professors who tell you the percentage of your portfolio in fixed income should be equal to your age. I'm 65 right now, and that has nothing to do with how much of my portfolio is allocated to fixed income. I have been a good steward of my money over the years, and municipal bonds play a big role in how I invest. I use a client of ours, Skip Morton at RBC Wealth Management. He is, in my opinion, the best adviser for my municipal bond portfolio. Bonds are something I had no real interest in during my Wall Street career. I have been a stock-, options-, and futures-focused adviser. So when it comes to munis, I want the best help. I told him to always think of his mother. If he would put it in her account, then it's okay for my account. I was just kidding on that. I did tell him that he had a blank canvas and to paint the most beautiful picture he could paint on it. He has. For this portfolio I am mostly interested in a laddered effect where bonds each year mature, and actually pay me my money back, and then we reinvest in possibly higher rates if they have risen. This is the reason for a laddered portfolio. So it is high-quality bonds I want, and bonds that are pre-refunded, or insured or in a high-quality state like Virginia, not Michigan. Fluctuations in the value of the portfolio are not important, although sometimes Skip will take a profit in a bond when he can reinvest it in the same or higher quality with a pickup in yield. I love watching this painting because one day

it will be a big piece of what I live on. With Skip handling it, I can focus on things I'm better at like covered writing.

Fixed income is always battling the stock market for investor dollars. It is considered the safe part of an investor's portfolio while the stock side is considered the volatile side. However, we found out in 2008 this is not always the case. In 2008, the margin clerks took control and began raising capital for the banks and everything was sold indiscriminately. Nothing was saved. So now what? Now, the age-old adage of fixed income's being the safe side of the portfolio is not necessarily true. Not only that, but in a rising rate environment, fixed income is a killer to the portfolio if an investor has to sell that part of his portfolio for whatever reason. He is at the mercy of the interest rate market, and in many cases that can be merciless in deed. Given these scenarios, how safe are those "lifestyle funds" that increase fixed-income exposure as the investor gets older? I would say not so safe if they find themselves in a rising interest rate environment. This is why a laddered effect makes so much sense. Bond funds are at the mercy of interest rate fluctuation. With rates at all-time lows right now, "do you feel lucky?" This is why it's so important to keep your eye on the ball—I mean the chart. One of the most respected fixed-income managers in the United States said in the spring of 2011 that he sold all his treasuries with longer maturities but kept the short-term paper, which is generally considered a cash substitute. One year later, *Time* magazine interviewed him as to why he made such a major bet. His response was that he "felt" bonds had gone as high as they were going to go. Had he only looked at this chart he would not have sold the bonds. As you can see in Figure 9.1, interest rates (as represented by the U.S. Treasury 30-Year Yield Index) entered a negative trend in May 2011, indicating rates were falling. Due to the inverse relationship between rates and bond prices, this change signaled bond prices were rising.

Since the spring of 2011, the long bond is up over 32 percent at this writing. Here's the point once again. It is the irrefutable law of supply and demand that causes all price changes, even in bonds. All the fundamental work in the world will not help you if there are more sellers than buyers willing to buy for whatever reason. In 2008, the reason was banks needed cash, plain and simple. How do you get cash? Sell stuff. Today, it's all about whether the euro survives, will Greece default, will Spain default, and who is in the wings ready to default? Tomorrow, it will be that everything is just great, they will kick the can down the road once again, and everyone is happy. Then the next day, all hell breaks loose, and Ireland's back in trouble. It is nonstop news. It's a fire hose of useless information on a day-to-day, minute-to-minute basis. The only thing that does not lie, obfuscate, or have an ulterior motive to get investors to do one thing or the other is the almighty chart.

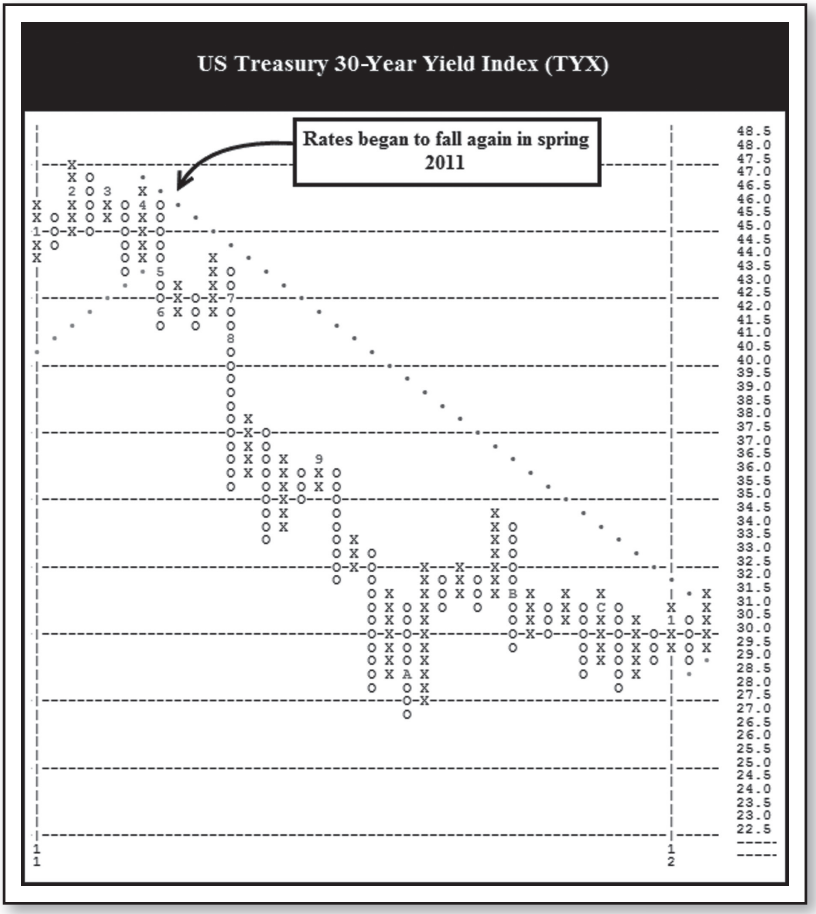


FIGURE 9.1 Fixed-Income Indicators: U.S. Treasury 30-Year Yield Index Point and Figure Chart

Learn to love it—it's all there is in the end. Here is an interesting tidbit and instruction on how the stock markets can decouple from the economic situation. Greece could not be in worse financial shape. However, by December 2012 the Greek stock market had moved up 75 percent from its bottom in June 2012. There is an old market adage, "buy when blood is running in the streets." It was running in the streets back then. Would you have bought Greece then or would you have preferred a 5 percent return in good old safe USA? The blood is once again running in the streets in Egypt. I bought the EGPT last week. We'll see how it turns out.

Does this mean we don't use fixed income anymore to reduce volatility of a portfolio? The answer is no. We still use this tool for risk mitigation, but if fixed income falls out of favor we have to take this into consideration and adjust the

portfolio as needed. There is no set it and forget it portfolio. Someone has to be driving the bus even if it's a computer system doing the driving. As a general rule, fixed income in an account can considerably mitigate risk, but you better understand if it is in favor or not, unless your direction is a laddered portfolio like I have. In our money management division, one account we manage is a model that combines stocks that possess strong relative strength (RS) with a bond allocation that makes up about 40 percent of the total portfolio.

The one thing we endeavor to do with respect to the fixed-income indicators is to determine the probability of interest rates rising or falling. We accomplish this by keeping close track of the Point and Figure chart of all fixed-income instruments. I have never seen another method that can bring you closer to the right answer than what we do with our charts. In 1994 the indicator we used to guide us on interest rates was the Dow Jones 20 Bond Average. I discussed it in the first edition of this book. Eventually, Dow Jones stopped keeping the data. As time went on, the data we got became less reliable and we eventually discontinued maintaining the chart and picked up another bond index, the Dow Jones Corporate Bond Index, which has been just as robust. Looking at signals in the past can give us a grasp of how these indicators have operated and when the Dow Jones 20 Bond Average was in existence it was fantastic. When it was on a buy signal, you could darn near take it to the bank that rates would fall and bonds would rise.

Let's go back in time and look at an example of a call we made using the Dow Jones 20 Bond Average. In January 1995 it gave a buy signal, signaling higher bonds and lower rates. By June of that year bonds had risen sharply. By following the indicator you would have been on the right side of the equation, long bonds. The following is a story from *BusinessWeek* (June 19, 1995):

> **Hang On: More Surprises on the Way**
>
> Bond funds did a dramatic about-face from 1994, when virtually every category of bond fund was in negative territory. But in 1995s first half, every category sported positive returns. Only two fund groups—short-term world income and government adjustable-rate mortgage—failed to generate a return of more than 8 percent. Government bond funds investing in Treasuries took the top slot, with an 11.5 percent average return, boosted by the powerful rally in the bond market. But many government bond fund managers, having built up more conservative positions in short and intermediate maturities in the wake of last year's market rout, didn't participate in much of the rally. World bond funds came in second, gaining 10.2 percent.
>
> *By Suzanne Woolley, New York*

I thought back to January 1995 and how we had been long bonds because our bond indicators had given a buy signal. Then I thought about all those high-paid—and I mean high-paid—bond analysts and traders who missed the whole move just like they did in 2010. What were they looking at or evaluating that caused them to be totally opposite the trend in bonds? As I have said, we subscribe to the Yogi Berra School of Investing: "You can observe a lot just by watching." The charts are silent, yet all-knowing. All you have to do is watch and have faith. There is an old saying, "Those who know don't speak; those who speak don't know." The charts don't speak. They are there for your observation and typically the signals are long term in nature.

So let's discuss the Dow Jones Corporate Bond Index, which is what I consider as the modern-day version of the Dow Jones 20 Bond Average we used to follow years ago. This index is composed of 96 investment grade issues that are divided into the Financial, Industrial, and Utilities sectors. As well, they are further divided by maturity with each of the sectors represented in the 2, 5, 10, and 30-year maturity. All issues are equally weighted and strict rules for liquidity, rating and issuers are applied, and the index is reviewed monthly. We use the price return value for the index, instead of the total return index because a total return index will have a positive bias, and we feel that evaluating the index itself is more appropriate for our needs of determining strength or weakness in the corporate bond area. Almost every day I get a call from one of our professional clients asking what I think of interest rates. I never give a gut feel. Right now in fall 2012, I feel rates will rise significantly. So why do I have this feeling. It is directly tied to the little—and I mean little—outside babble I allow into my mental sphere of consciousness that makes me feel this way. These feelings are best left for cocktail parties and historical banter. In the real world, where real money is invested, the first thing I look at is the Dow Jones Corporate Bond Index to get a good feel for the current interest rate environment. I have to put aside all gut feelings and look at "what is." All you have to do is look at Figure 9.2, and you will see that in June 2009 the Index gave its first buy signal following the meltdown of 2008 and it was off to the races. From its bottom in 2008 at around 85, it has risen to a current 122 in late 2012.

As you can see in Figure 9.2, the Dow Jones Corporate Bond Index (DJCORP) is longer term in nature. You can see by the chart that the trend is still up, so rates are nowhere near rising yet. If we want to get a nearer-term outlook, we can adjust the box size down. Recall that the smaller the box size, the more movement and thus the shorter term in nature. When evaluating the DJCORP chart, we look at buy and sell signals as well as bullish and bearish support and resistance lines. That is, when the DJCORP is on a buy signal, it

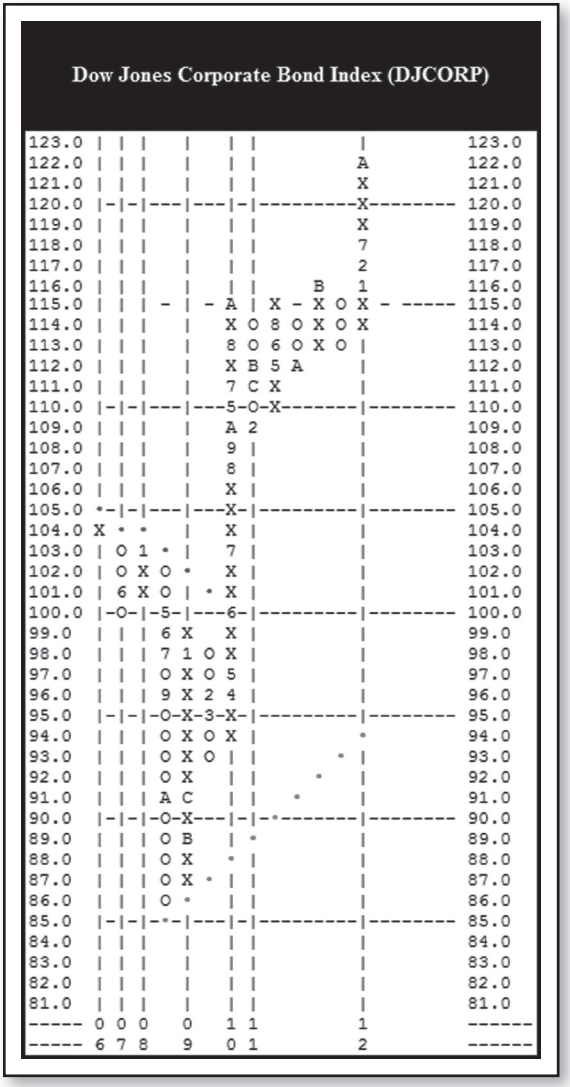


FIGURE 9.2 Dow Jones Corporate Bond Index

suggests higher bond prices and thus lower rates. Conversely, when this chart is on a sell signal, it suggests lower bond prices and higher rates. The bullish support and bearish resistance lines are like Interstate 95 North and South as we discussed in earlier chapters. I would look at the DJCORP Bond Index once a week. In fact, you know what? The easiest way to keep track of it is simply set an alert on each chart. Bring the chart up, and then look in the top left side of the chart. You will see a tab that says set action price or set activity

alert. When you do this you are simply advised over your e-mail or via text if anything happens that requires your attention. Say, for instance, you set an alert for a reversal in the chart to O's. If this happens you will be alerted. This helps give you your life back so you can do other things rather than becoming a slave to charts. This is where technology can do much of the work; but you still have to drive the bus. I look at the alerts as cruise control buttons.

In addition to the DJCORP, we have a number of indicators to measure the treasury markets. Sometimes the best thing to do is just go to the source. For us, that means looking at the supply-and-demand relationship. Just as we can chart the supply-and-demand picture for equities, we can also do it for the fixed-income exchange-traded funds (ETFs), yield indices, and bond futures. When bonds are rising, we will see positive patterns for both the bond futures and fixed-income ETFs. If bonds are rising, that means rates are falling so conversely we will see negative patterns from yield indices, which measure rates themselves. The exact opposite picture will develop when rates are rising. That is, we will see the yield indices showing positive patterns and positive trend. If these charts are positive, by definition, the chart patterns of the bond futures and fixed-income ETFs will be giving negative Point and Figure patterns and generally trading below the bearish resistance lines. Figure 9.3 details some of the bond futures, yield indexes, and fixed-income ETFs we look at to get a composite picture of the trend of rates.

FIGURE 9.3 Fixed-Income Indicators

Bond Futures	
T-Notes Continuous Chart	TY/
T-Bonds Continuous Chart	US/
Fixed-Income ETFs	
iShares Barclays 20+-Year Treasury Bond	TLT
iShares Barclays 7–10-Year Treasury Bond	IEF
iShares Barclays 1–3-Year Treasury Bond	SHY
iShares iBoxx $ Investment Grade Corp. Bond	LQD
iShares Core Total U.S. Bond Market	AGG
iShares Barclays TIPS Bond	TIP
Yield Indices	
13-Week Treasury Bill	IRX
30-Year Yield Index	TYX
10-Year Note Yield Index	TNX
5-Year Yield Index	FVX

In Figure 9.4 we compare the 30-Year Yield Index (TYX) to the 20+-Year Treasury Bond (TLT), as an illustration of the inverse relationship between rates and bond prices. As you can see, in March 2011 the TYX reversed into O's, breaking through its bullish support line in August 2011. Consequently, TYX's trend turned negative telling us that rates had hit I-95 South. Unsurprisingly, at around the same time, the TLT reversed into X's, breaking through its bearish resistance line in August 2011. This move changed the fund's overall trend to positive, suggesting higher bond prices. Understanding the interest rate picture can have implications across all of the investing you do. In your 401(k), it might prompt you to take a closer look at the bond funds available that present positive technical pictures.

It reminds me of the following Zen story (source: www.rider.edu/~suler/zenstory/zenstory.html):

> After 10 years of apprenticeship, Tenno achieved the rank of Zen teacher. One rainy day, he went to visit the famous master Nan-in. When he walked in, the master greeted him with a question, "Did you leave your wooden clogs and umbrella on the porch?" "Yes," Tenno replied. "Tell me," the master continued, "did you place your umbrella to the left of your shoes, or to the right?" Tenno did not know the answer, and realized that he had not yet attained full awareness. So he became Nan-in's apprentice and studied under him for 10 more years.

In the end, the market will do what it wants to do. Our job is to listen and be aware of the market's movements by examining the charts and then take the appropriate actions.

At this point in the book, you have really learned all of the concepts there are to know. It's just a matter of applying those concepts to different areas of the market. For instance, let's take the RS tool that is applied to individual equities and apply it to the fixed-income markets. Using this dynamic tool, we can compare the fixed-income markets to the equity markets. In addition, within the fixed-income markets we can find those areas with the weakest and the strongest relative strength. For this comparison we will use the iShares Barclays Aggregate Bond Index (AGG) and the S&P 500 (SPX). The iShares Barclays Aggregate Bond Fund "AGG" is a measure of a broad spectrum of different types of bonds as well as maturities and quality, so it is a good overall picture of the bond market. In the RS chart, Figure 9.5, we will use a smaller scale than the traditional equity chart because generally, the volatility is lower in bonds, and we can still look at the buy and sell signals for guidance as to when we want to overweight fixed income in the portfolio. The darker

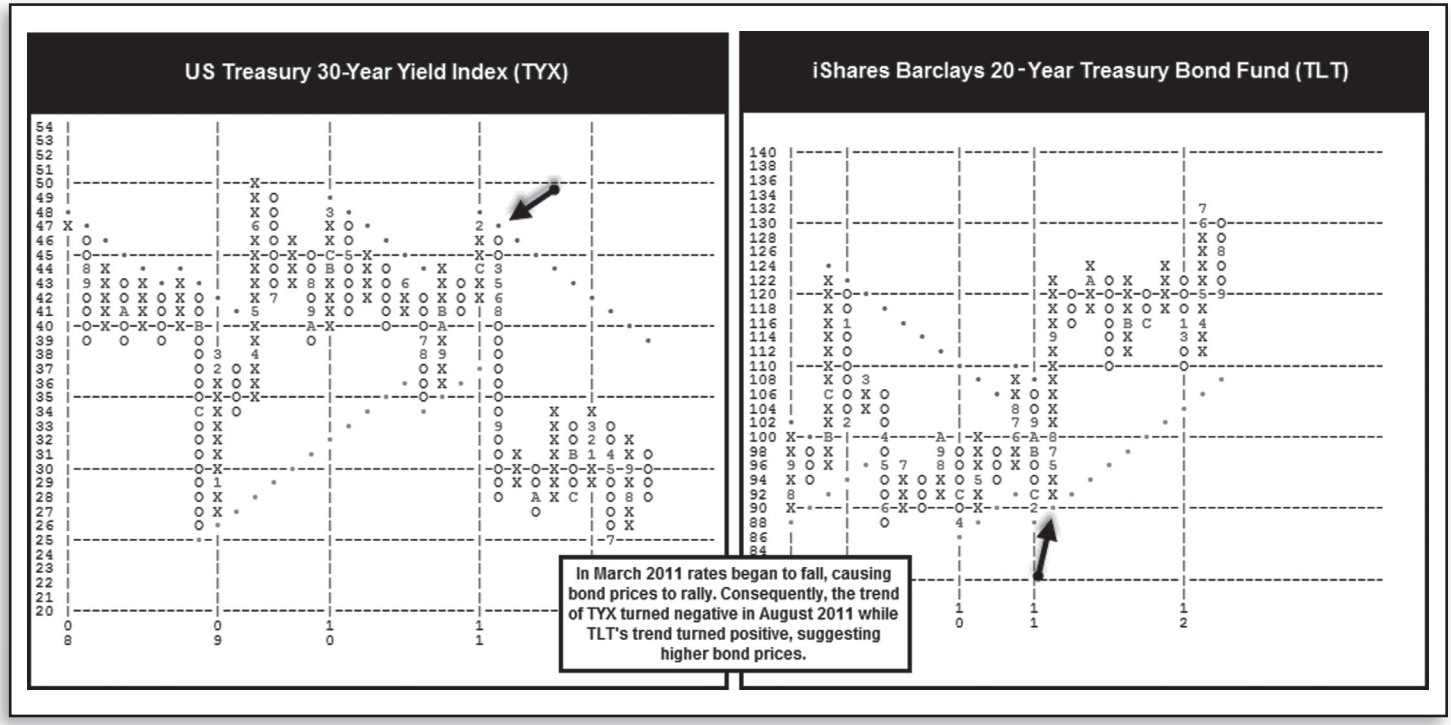


FIGURE 9.4 Long-Term Bond Charts

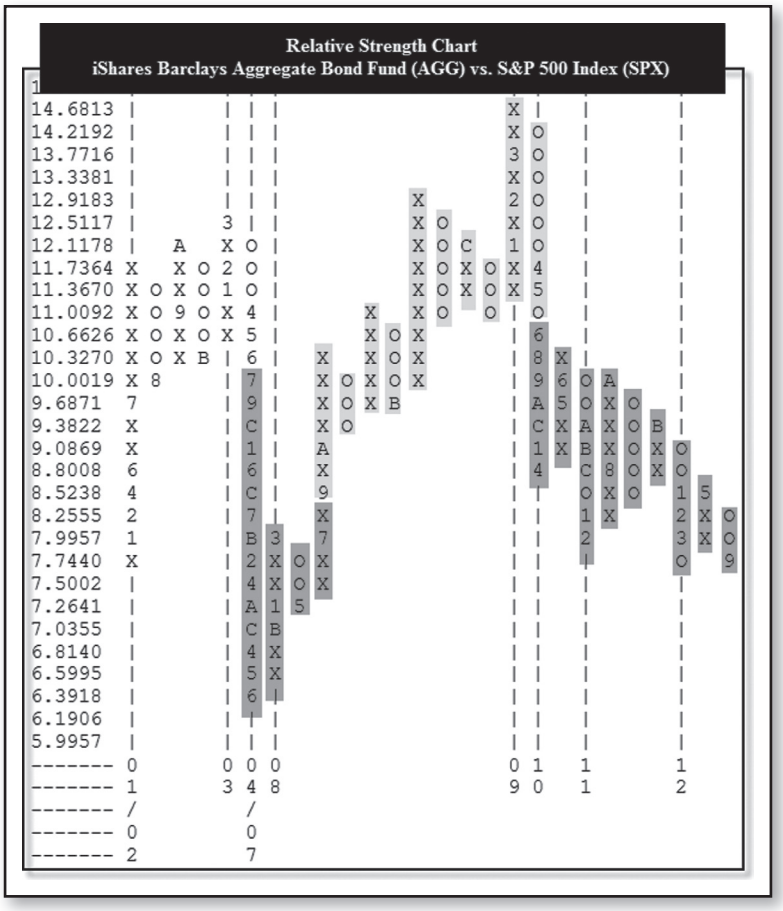


FIGURE 9.5 RS Chart: S&P 500 versus Aggregate Bond Fund

shaded areas indicate the time period when this RS chart is on a sell signal and the denominator, the Standard & Poor's (S&P) 500, should outperform. The lighter highlighted area indicates a time during which the RS chart is on a buy signal and suggests the numerator, AGG, should outperform. As with most RS charts, once a trend is established, it tends to last several years. And you see in Figure 9.6 that the RS chart has aptly guided us with respect to the weighting of fixed income versus equities in the portfolio.

FIGURE 9.6 **Signal History: SPX vs. AGG**

Signal	Date
Sell signal	July 31, 2003
Buy signal	July 15, 2008
Sell signal	June 1, 2009

Dates	Signal	AGG	SPX
7/31/03 to 7/15/08	Sell Signal	1.84%	22.68%
7/15/08 to 6/1/09	Buy Signal	-0.31%	-22.39%
6/01/09 to 9/30/12	Sell Signal	11.93%	52.80%

Performance numbers are pure price returns not inclusive of dividends, fees, or other expenses

FIGURE 9.7 Performance Data for AGG vs. SPX

From July 31, 2003, to July 15, 2008, the chart suggested that equities were outperforming bonds and therefore you should be long the SPX. You can see in Figure 9.7 that buying and holding the SPX resulted in a 22.68 percent return for the SPX versus buying and holding the AGG, which went up only 1.84 percent. On July 15, 2008, the bond-to-equity relationship changed, and the chart's buy signal suggested you move your investments to the AGG.

From July 15, 2008, to June 1, 2009, the AGG was down 0.31 percent, while the SPX was down 22.39 percent. Again, only appreciation or depreciation is calculated. Though the AGG was slightly down during this period, this shows massive outperformance by the AGG. I am always amazed at the accuracy of these RS charts. Just try it. Put in any symbols to compare, and then click the performance tab at the top of the chart. You too will be amazed. On my Welcome page on our system, I have all the comparisons I want to view on a daily basis. They are updated each night and displayed for me to see each morning. At the time of this writing, the chart is both on a sell signal and in a column of O's, suggesting that the SPX is favored on both a short-term and a long-term basis. Remember that this whole exercise is between only two investment vehicles. In the real world, you would have other asset classes like international equities and commodities to deal with. This is where our Dynamic Asset Level Investing (DALI) comes into play. It's an important tool on the web site that tells you which asset classes to be in.

Another concept that you've learned that can also be applied to our fixed-income fund analysis is the Bullish Percent. We chart bond funds using the Point and Figure method, and then use the basic Bullish Percent method, where we measure bond mutual fund charts for buy signals, just as we do for stock and equity funds. Figure 9.8 is an example of Bullish Percent for the group All Fixed Income Funds (BPMU99), which covers over 3,000 distinct bond portfolios.

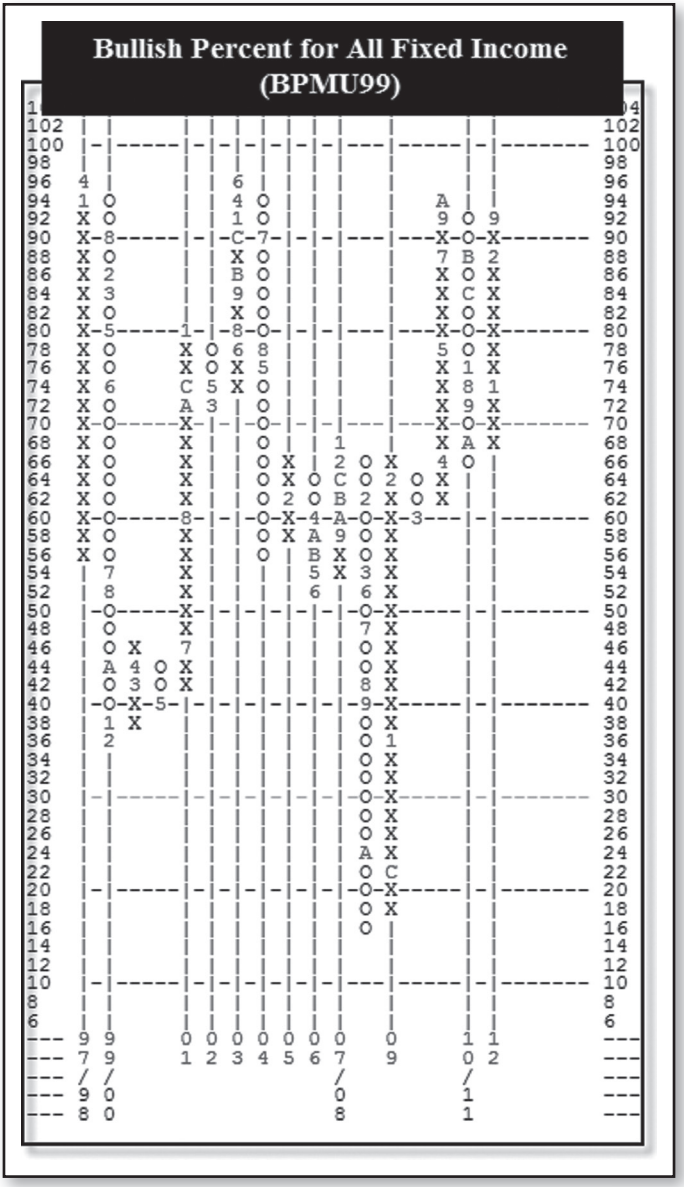


FIGURE 9.8 Bullish Percent for All Fixed Income

This indicator tells you the percent of the entire fixed-income fund universe that is on a buy signal on their default trend chart. (We also have Bullish Percent charts on subcategories of the fixed-income universe). The back-and-forth action from X's to O's is interpreted the same way that you would interpret the stock Bullish Percent charts you learned about in

Chapter 6. You know what I just did as I proofed this section? I went to the chart BPMU99 and set an alert to be notified of a reversal in this chart. Did you do this? Don't you think you should?

In recent years there have been two very unique products that have been introduced that, in my opinion, change portfolio management with regard to the fixed-income portion of a portfolio. Here's the problem. In the past, to give a customer true diversification in bonds; a broker typically bought their clients a bond fund. These funds were a collection of various types of bonds with various maturities. The fund operated in perpetuity. Bonds were bought and sold in the fund by the manager, but the problem came when the investor needed to sell the fund for whatever reason. Maybe it was retirement, to buy a house, or maybe the investor needed money for whatever reason. If interest rates had risen since he bought the fund, the value of the fund would be down. In many cases, investors took losses on that part of the portfolio billed as stable. Suze Orman, the great champion for the individual investor, suggested avoiding bond funds for this reason. However, in 2010 and 2011, two new ETF lineups came into existence. One was the Guggenheim Bullet Shares, offering defined maturity corporate bond funds. Now the investor can align the bond maturities with his future liabilities. Go to this site for a complete discussion of these ETF's: www.guggenheimfunds.com/bulletshares. In the fixed-income arena, these bond ETFs are truly unique. The investor, for the first time, can get true diversification in his bond portfolio and avoid interest rate risk. It is a relatively new product, and at this time I don't think many advisers know much about them. Visit the site and learn all about this unique offering.

Now, what can you do if you are a high-income individual and need municipal bonds that are tax free? If you do not create your own diversified municipal bond portfolio with laddered maturities, you might consider the iShares target date municipal bond series. I plan to make some of these part of my own portfolio. Go to www.ishares.com, to learn all about this unique product.

The future is in this type of portfolio modeling. At Dorsey, Wright and Associates, we maintain many models, using our RS work. Our computers do nothing more than what we can do by hand. But with the thousands of different securities, bond funds, ETFs, and commodities, it is virtually impossible to actually perform these calculations by hand anymore. At Dorsey, Wright, 25 years ago, the rite of passage for an intern was to update the RS charts by hand. We could do about 200 calculations a week. It worked for us

a quarter of a century ago, but today it's a different story. The world is open for business, and to handle this type of volume you must teach the computer what you want it to do, and then do it millions of times a day. One of the models we have available for our subscribers is our iShares Fixed Income Model. This Model is auto-managed for you. If you wanted a fixed-income position in your portfolio, then this model would be one of the most logical choices.

The purpose of the iShares Fixed Income portfolio is to identify major themes within the fixed-income area of the market between the different subasset classes. In other words, the Model is designed to cull out the strongest areas within fixed income but it is not designed to take into account absolute risk in the fixed-income class itself. Within the fixed-income asset class, the portfolio will attempt to capture the strongest trends and avoid the weakest trends. Relative strength compares areas within the fixed-income markets to one another to rank the strongest on an RS basis to weakest on an RS basis. The systematic and rules-based approach also allows us to eliminate the human or "gut feel" trades as our research has found the more we let the system do the work, the better the returns will be.

The Model is updated on a weekly basis. If a change takes place, then those who follow the Model are alerted of the change on our web site and it is up to them to make a change. In addition, the real future of investing is being done in my portfolio at Dif Broker (www.dif.pt), where they have a DWA Model Manager Service. When a change takes place in a model, the DWA

FIGURE 9.9 **iShares Fixed Income Model Performance History**

Year	Start Value	End Value	Percent Return (%)
2000	100,000.00	106,774.47	6.77
2001	106,774.47	108,365.22	1.49
2002	108,365.22	123,059.85	13.56
2003	123,059.85	144,565.53	17.48
2004	144,565.53	161,120.68	11.45
2005	161,120.68	158,766.39	–1.46
2006	158,766.39	161,728.21	1.87
2007	161,728.21	161,678.60	–0.03
2008	161,678.60	169,015.55	4.54
2009	169,015.55	194,794.48	15.25
2010	194,794.48	188,981.37	–2.98
2011	188,981.37	201,618.24	6.69

Note: Returns are pure price returns, not inclusive of dividends, fees, or other expenses.

computers communicate with the DIF servers, and the portfolio is automatically updated with the change. I am then notified that the trade took place as well as a briefing of what was bought and sold. When all is said in done, it's the power of RS that makes these portfolios possible.

As you can see from the historical data below in Figure 9.9, through 2011, the portfolio will not outperform every quarter or year, but when there are wider differences between the best- and the worst-performing areas, the Model is designed to capture that potential. During periods when leadership is changing or performance is choppy, the model will tend to underperform. Figure 9.9 shows the yearly returns for the Model. Since December 31, 1999, the iShares Fixed Income Model has performed well, showing a cumulative return of 106.90 percent through the end of September 2012, while the iShares Barclays Aggregate Bond Fund (AGG) is only up 52.33 percent. Keep in mind that these returns do not include the dividends received from the investment in the Model. These results are calculated assuming 100 percent investment at all times in the Model and do not take into consideration commissions or other fees associated with implementing the Model. Returns listed prior to July 28, 2010, are hypothetical backtested returns.

CHAPTER 10

Utilizing the Exchange-Traded Fund Market

Timing Is Everything

It is said that timing is everything. In my life I certainly have found this to be true. I remember my early Navy days and how just four short months changed my life. I joined the Navy with the express purpose of entering underwater demolition (UDT) and then move on to SEAL training. When I graduated from Boot Camp, I was told I had to first go to my duty station, Naval Air Squadron VP31, and then apply for Underwater Demolition Team. I did so and was accepted. Fortunately for me, I was stationed just down the road from the UDT training school while I waited for the next class to start. Since I was a Red Cross water safety instructor, the squadron personnel department placed me in Air-Crew Training. They had been waiting for a water safety instructor to come through for months. I was immediately placed in the deep sea survival instructors group. My duties were to teach pilots who were heading to Vietnam how to survive in the ocean if they had to abandon their plane.

As an enlisted man, the position as a deep sea survival instructor was as good as it could get. So, when my underwater demolition class was about to begin, I decided to postpone the class for the second half of my enlistment if the squadron would allow me to stay in my survival instructor position.

The squadron was perfectly happy to have me stay on, so the die was cast. I simply put on hold my desire to become a U.S. Navy SEAL until my last two years of enlistment. Well, all good things must come to an end, and my first two years of shore duty were rapidly expiring. I had a choice—go to sea or go back to underwater demolition class. I chose UDT/SEAL training.

I was accepted to class again after spending three months getting in shape for the entrance test a second time. I ran into a little administrative wrinkle, though. Since I waited for the second half of my enlistment to attend class, the Navy required I extend my enlistment by four months to qualify for having two full years of naval duty following the end of training. Since I had made a commitment to go back to college at the end of my enlistment, I decided not to extend. As I look back in retrospect, this was a major turning point in my life. I was transferred to Vietnam on an Aircraft Carrier, the Kearsarge CVS 33, already positioned in the South China Sea. In fact, they flew me out to the ship on a mail plane. Experiencing an arrested landing on an aircraft carrier that was under full steam in the middle of an ocean is something I'll never forget.

I spent the next two years both at sea and on shore in San Diego. When I was honorably discharged from the Navy, I immediately went back to college. I'm sure, had I chosen UDT, I would not have gone back to college and would more than likely own a dive shop in some part of the world. It's interesting how life is full of choices. I made the right choice for me and went back to college, but at the same time I lost an opportunity to test myself that few others have. Soon after graduation and a short stint as a production supervisor at a winery, I found employment on Wall Street as a stockbroker at Merrill Lynch. One decision, not to extend my enlistment for four months, profoundly affected how my life turned out. Timing is everything.

During World War II, the United States was cut off from rubber produced in Southeast Asia just as demand for the rubber was increasing significantly. Do you know what happened? We made synthetic rubber through a large national effort to both increase the output and quality of this rubber. Here is the clincher, though. After the war, we went right back to natural rubber even though we had weaned ourselves off it by creating high-quality, synthetic rubber. Why would we do that? It doesn't make sense. We had already broken away from the addiction to Southeast Asian rubber, but we went right back. The reason is simple: we just weren't ready as a society for synthetic rubber. The "S" curve for natural rubber had not reached its end. Many years later we gravitated back to synthetic rubber, but only when we were ready as a society to accept it. The war accelerated the process of substitution beyond what was natural. After the war, we settled back to the

natural curve. In essence, we went right back to the same place on the "S" curve we were when the war started.

It's like the technology gap. New technologies emerge while we fight tooth and nail to hold on to the old guard. I remember my company had to drag me away from Word Perfect to begin using Microsoft Word when the quality of Word was already superior to Word Perfect. I wanted the old technology I was used to. All products have a life cycle. The carburetor on automobiles was superseded by fuel injection. The eight-track tape was replaced by the cassette tape, and the cassette tape was replaced by the compact disc (CD), and the CD was replaced by the MP3, and on and on. Financial products are no different. They have a time and a place, and until the time is right, substitution for the new will be accepted slowly.

History of Exchange-Traded Funds

This chapter could be a book unto itself. Let's go back to the beginning. I remember my first thoughts on securitizing a basket of stocks came from working with the PHLX Gold & Silver Index. I knew early on, before exchange-traded funds (ETFs) hit the market, their viability as an investment vehicle was undeniable. I remember vividly my conversations at the time with Joseph Rizzello, head of product development and marketing at the Philadelphia Stock Exchange (PHLX). The Philadelphia Stock Exchange was one of the most progressive and forward-thinking exchanges in America. In 1983, the PHLX had just come out with a new product: options trading on indexes. It was truly a revolutionary idea developed by Joseph. He was also one of the real thinkers on Wall Street. Much like the first commodity-based ETF was in gold, the first index options traded were on the PHLX Gold & Silver Index (XAU). This was the first product of its kind where an investor could simply make an investment in an option on an index of stocks in a particular sector, rather than having to focus on one stock itself.

At the time, the index was priced around the $600 level, and the options were naturally very expensive as well. That would be tantamount to trading options on a $600 stock. It hit me one day that the real product was not the options that traded on this index, but rather the ability to buy the index itself. Having been a stockbroker in the past, I knew exactly what would have made the most difference in my business, and it would have been the ability to buy an index, a basket of stocks with a common theme. What the PHLX needed to do was split the XAU 10-for-1, making it a $60 per share

index, and then securitize it. In other words, trade the XAU as a $60 stock, a stand-alone product. Then, add the options for those who were so inclined.

I knew in my heart that this had to be a fantastically successful product. It was as clear as a bell to me. I went to Joseph Rizzello, who was a close friend of mine. He concurred. It would be a huge undertaking to create a product like that. It would be expensive to accomplish and it was very forward thinking, maybe in fact, too forward thinking for the time, just like synthetic rubber was after WWII.

Nothing happened with that idea for the XAU. But Joseph Rizzello and the PHLX did come out with a product called cash index participation (CIP) units, on the S&P 500 (SNP) and Dow Jones (BIG). These CIPs actually traded on the PHLX. They were theoretical baskets of stocks that acted like an index portfolio. You owned the unit in perpetuity and it had a cash-out provision. If the cash-out provision was drifting away from the net asset value, those long the unit could ask for the net asset value of the unit. This prevented short sellers from manipulating the value of the unit. Because you owned the unit, when any components went ex-dividend, you would collect the dividend by debiting the short sellers and crediting those long the unit. The CIP could also be margined.

It was a fantastic product, but doomed from the start. I traveled all over the country with the PHLX holding seminars to packed houses—I mean packed houses of 500 to 600 brokers and professionals. The investment world wanted this product. But it was doomed because the futures exchanges decided to sue for the product. They suggested that the product was a futures contract and should come under their purview. This lawsuit resulted in a famous ruling called the Easterbrook Decision. The judge ruled in favor of the futures exchanges. While this instrument had all the elements of a security, it also had an element of futurity. Therefore, the courts ruled in favor of the futures exchanges. The futures exchanges, after winning the lawsuit, simply took the product and shelved it—"Dead on Arrival." As Paul Harvey used to say, "Now you know the rest of the story."

That decision spurred the workings of the ETF that we now have in our arsenal of trading tools, but it came from an unlikely source. The Toronto Stock Exchange came to the PHLX to learn how the CIP was created. The Toronto Stock Exchange created the first ETF that had staying power. It was called TIPS (Toronto Index Participation Units), which traded on the Toronto Stock Exchange. Following the debut of the TIPS, the American Exchange created the SPDRs (SPY) and now we have numerous vehicles to invest in that have the same characteristics as the CIP we first traveled the country marketing. Once again, timing was everything.

Today's Exchange-Traded Fund Market

The ETF market exploded in the late 1990s with the popularity of the SPDRs and the QQQs, representing the S&P 500 and the Nasdaq 100, respectively. Merrill Lynch then introduced the HOLDRs, and Barclay's burst onto the scene with the most comprehensive listing of index-based, sector-based, and international ETFs named iShares. Sector select SPDRs became available, and other companies like Vanguard, well known for its vast mutual fund offerings, entered the scene with the lowest-cost ETFs available. Since then, we have seen more ETF providers emerge, including Powershares, where we license underlying indexes for four ETFs: the Technical Leaders Portfolio for U.S. stocks (PDP), the Developed Markets Technical Leaders Portfolio (PIZ), the Emerging Markets Technical Leaders Portfolio (PIE), and the SmallCap Technical Leaders Portfolio (DWAS). There are now over 4,000 ETF's worldwide that trade in 2013. I would have never guessed this product would find such acceptance worldwide, but then again I knew it was the right product for investors in 1983.

Before we get into the ins and outs of using technical analysis to trade and invest in ETFs, let's start out with some basics. There are a couple of different types of structures to the ETFs, but the basic premise is that this vehicle allows us to buy a package of stocks wrapped in one vehicle, much like a mutual fund. When someone asks me what an ETF is, I respond by saying: "It is simply a school of fish." ETFs are composed of stocks that are similar in nature, like oil stocks or technology stocks, or they are similar in how they were selected, like our PDP, which is the 100 strongest relative strength (RS) stocks trading in the United States. An ETF might consist of commodities or fixed income or an index of the leading stocks in any country like Malaysia. The versatility and ease of investing with ETFs brought a whole new methodology to DWA. We mix and match different ETFs to create a portfolio; more on this later in the chapter.

ETFs are different from mutual funds because ETFs do not trade at Net Asset Value (NAV). However, traders on the floor will arbitrage the stocks underlying the ETF if a price disparity develops, keeping prices in line. They are also different from mutual funds because they trade throughout the day. You can buy and sell anytime during the day using stop-loss orders and limits just like you would with a commodity or a stock. Also, like stocks and commodities, ETFs can be sold short. Many ETFs have options allowing for other strategies like the covered write and other methods to gain long or short exposure. ETFs are also transparent. That is, most mutual funds do not

list their current holdings and weightings. On any day, you could go to the web site of the ETF provider in question and find the current holdings for that fund and their respective weightings.

This is very important in the evaluation of the ETF as you will learn a little later in this chapter. There are a number of free web sites geared toward teaching you more about ETF structures and what's available as you begin to use this product in your investments and trading. For example, at www.etfguide.com. Dorsey, Wright also provides a comprehensive site you can use to search for ETFs and view their holdings, www.alletf.com.

The ETF landscape is changing so quickly that we aren't going to list every ETF available right now, as there are over 1,400 trading in the U.S. at this writing, with more on the way. All the charting capabilities to effectively manage portfolios of ETFs can be found at www.dorsey-wright.com. We also provide technical fund "scores" on our site that cannot be found anywhere else.

Exchange-Traded Fund Evaluation: Know What Is Inside

The most important consideration when determining whether to buy or sell and how to manage a position is to examine the ETF chart you are purchasing or selling. Some ETFs have a long enough history to evaluate the chart itself, but in those cases where there isn't enough history on the chart of the ETF, we examine the underlying index. You see, every ETF is designed to track an index, and in most cases the index will have at least three years' worth of history, if not many more. The job of the ETF provider is to make sure the ETF you purchase actually replicates the performance of the index, and they do a great job at it. For instance, the iShares COMEX Gold Trust (IAU) began trading in January 2005, so that's as far back as our Point and Figure chart goes. However, the IAU is designed to track the price of London Gold Fixed PM whose symbol on the DWA web site is UKGOLD. To get a longer-term perspective on this ETF, it would be entirely appropriate to look at the chart of UKGOLD for guidance as well as the chart of the IAU.

Another question we often get is, "What is the best ETF to purchase when the Bullish Percent Index chart (an important risk evaluator) reverses up?" The short answer to that question is that there isn't just one, there are many right answers to this question. But I want to explain why. If you recall

from Chapter 6 on the NYSE Bullish Percent, this type of indicator is a one-stock, one-vote indicator. This approach is different than the way indexes are typically composed. There are three basic ways indexes are composed. One method is to price weight. In price weighting, the higher the price of the stock, the more weight it carries within the index. This is the way the Dow Jones Industrial Average is priced. Another way to weight an index is by capitalization. That is, the larger capitalized the stock (shares outstanding multiplied by price), the more influence it has on the index. This is the most common way to weight indexes and ETFs. With this type of weighting, just a handful of stocks can control the vast majority of an index's move. You will see this in our example in just a minute. Finally, we can weight an index equally. That is, each stock gets an equal vote. This is the way the DWA sector indicators and Bullish Percents are constructed.

The universe of equal-weighted ETFs is expanding. The first was an equal-weighted index on the S&P 500 brought to the market by Rydex (now Guggenheim), and the symbol is RSP. The way the RSP and the SPX moved from December 31, 1999 to July 31, 2012, is like the difference between day and night. This is a total eye-opener for most investors, who don't even know there are two S&P 500 indexes. The equal-weighting effect on the RSP caused this index to significantly outperform the same S&P 500 Index (SPX) that was capitalization weighted. The returns are amazing. During this period, the SPX was down 8 percent and the RSP was up 71 percent. Which one of those would you have liked to have in your portfolio? If you were dealing with an adviser who didn't understand how to compare the two, and that is most of them, you would have owned the SPX, the capitalization-weighted index. It's all you see on TV, so why wouldn't you have been in the dark on this concept? I'll tell you this much—if I were an individual investor, I would have wanted to be working with an adviser who knew to make that change in my portfolio. In real numbers, $1 million would be worth $920,000 versus a portfolio worth $1,710,000. You pick. Is that not amazing? Both are S&P 500 indexes, both are composed of the same underlying basket of stocks, but one is up 71 percent and the other down 8 percent. Only price movement was considered since both have the same dividends.

The SPX is also the benchmark index all money managers are pitted against. However, this divergence in performance points to the fact that in the stock market we sometimes have a bull market in stocks and sometimes we have a bull market in indexes. The latter is generated by the capitalization weighting of the index. By looking at the two returns it is clear that we have

been in a stock market, not an index market. Think of a capitalization index like the House of Representatives. The states with the most people have the most representatives. California has more votes than Rhode Island. An equal-weighted index is like the Senate. Each state has two senators no matter the size. California has no more say in the Senate than Rhode Island has.

In 1998, we were in a bull market in indexes. This was when the capitalization-weighted indexes were in favor. The top handful of stocks in the S&P 500 pulled the index to new highs, while the smaller stocks that have little weight underlying this index were going down. Conversely, in 2000, the opposite happened. The small-cap stocks caught fire, while the big stocks that typically push and pull the capitalization indexes turned cold as winter. This had the effect of making the market look like it was in a bear market when in fact more stocks were going up than down. This is why it pays to have an operating system in your head to understand the mechanics of the market. The Point and Figure method of analysis is the operating system that we have found most effective and easy to learn. Remember, in the stock market things aren't always what they seem. This is especially true of the young media reporters who have been around Wall Street for only a few years since they graduated college with a degree in journalism.

At present, most ETFs are capitalization weighted, and therefore it's very important to analyze the chart of the ETF you are actually buying and then evaluate the top holdings of that ETF. You might find that the highest percent holdings in a particular sector ETF are in one stock. This would affect how you view that sector. A great example of this would be the Drug sector. A look at this sector shows there are 151 stocks currently in this group. That means each buy or sell signal in the group can affect the Bullish Percent by about 0.67 percent. However, a look at the broad iShares Dow Jones Healthcare Index (IYH) shows an index very skewed toward just a couple of names. Pfizer (PFE) and Johnson & Johnson (JNJ) each have over a 10 percent weighting. If these two stocks were in a Bullish Percent Index with a 10 percent weighting apiece, and each were to move to a buy signal from a sell signal on its Point and Figure chart, it would mean the Drug Bullish Percent could jump 20 percent in a day. Because of this fact, we use the DWA Bullish Percent chart to alert to us a change within a sector or market's risk level, but we never just blindly buy a similar sector ETF. It must have good technical merits on its own.

What you find under the hood of the ETF is what will generate the move. Learn to look under the hood when evaluating the investment merits of any ETF. In Figure 10.1, we compare the iShares Dow Jones U.S. Financial Services Index Fund (IYG), Vanguard Financials ETF (VFH), and SPDR S&P

iShares Dow Jones U.S. Financial Services (IYG)		Vanguard Financials (VFH)		SPDR S&P Bank ETF (KBE)	
WFC	12.24%	WFC	7.11%	RF	2.92%
JPM	11.06%	JPM	6.27%	FITB	2.87%
C	6.92%	C	3.98%	KEY	2.87%
BAC	6.90%	BAC	3.95%	STI	2.83%
V	5.05%	BRK.B	3.31%	CIT	2.78%
USB	4.64%	USB	2.58%	JPM	2.76%
AXP	4.04%	AXP	2.41%	USB	2.75%
GS	3.67%	GS	2.20%	BK	2.74%
MA	3.48%	SPG	1.91%	NYB	2.71%
PNC	2.45%	AIG	1.50%	WFC	2.71%
Top 10 Wt.	60.45%		35.22%		27.94%

*Weightings as of approximately 10/15/2012

FIGURE 10.1 Exchange-Traded Fund Evaluation: Top 10 Holdings—IYG, VFH, KBE

Bank ETF (KBE). The top 10 holdings in the IYG make up over 50 percent of the fund's composition, while in the VFH and the KBE, the top 10 holdings account for only 35 percent and 28 percent, respectively, telling us they are more equally weighted. A closer inspection of the actual holdings reveals that Wells Fargo & Company (WFC) accounts for 7.11 percent of the movement in the VFH while accounting for 12.24 percent in the IYG. This doesn't make one ETF better than another, but rather you just need to be aware of the weightings when considering how the ETF will fit into your overall investment strategies. Remember, you can simply go to www.alletf.com for an instant evaluation of what's under the hood of all ETFs.

If WFC is one of the strongest stocks in the financial sector, then the IYG would be a good choice for purchase, as the fund has a higher weighting in WFC. However, if WFC has a weak chart pattern compared to other financial stocks, the KBE would make more sense, as it has only a 2.71 percent weighting in WFC. Or perhaps you have a large holding in WFC and wish to hedge that position by shorting an ETF. Then using the IYG would be the logical choice. This is also where RS tools can come into play, and RS charts could be made comparing the IYG to the VFH to KBE, similar to the RS matrixes seen earlier in this book.

With respect to international ETFs, you will find that some countries are more skewed toward certain sectors than others. In Figure 10.2, we have highlighted just a couple of international ETFs to show you how the movement of a particular sector can influence an international ETF. The iShares MSCI Italy Index Fund (EWI) is very heavily weighted in the Energy sector, but has no weighting toward the Healthcare sector. When you evaluate country ETFs, it is helpful to think about what the country produces. In the case of Australia, we know it is a large natural resources country. I think of it as "stuff in the ground." Conversely, the iShares MSCI Spain Index Fund (EWP) is very high in financials with a weighting of 42 percent, and a 0.85 percent weighting in materials, and iShares MSCI Brazil Index Fund (EWZ) has weightings of about 24 percent financials and 19 percent materials. I find this so interesting when you check under the hood. Things aren't always what they seem. Malaysia presents an interesting situation. It has the lowest volatility of any country that trades an ETF. It also has a high dividend. I do business in Malaysia and know the people and the country. It's a great place. I own this country ETF, the iShares MSCI Malaysia Index Fund (EWM), because of the low volatility and high dividend. I also like it because of its natural resources, but the ETF doesn't have any significant weighting in them. This ETF has a 30 percent weighting in financials and 14 percent in industrials, and basic materials come in at only 5 percent. The returns from each of these ETFs reflect those sector weightings. From December 31, 2006, to July 15, 2012, Italy was down 68.29 percent, Malaysia was up 57.25 percent, Spain was down 57.54 percent (my guess is that performance was European crisis generated), and Brazil was up 13.8 percent. There are ways to logically and sensibly go about the investment process. This does not guarantee profits, but it does guarantee you are doing the proper homework before you make a move, and we have found that over time this is the key to outperformance, plain and simple.

Trend Chart Evaluation

You know what? The reason you are reading this book is to somehow find a way to "cut to the chase." In other words, how can I get to the answer to the question of what to own as quickly as possible? The only way to evaluate thousands of symbols quickly is to use technology to do the work for you. Everything we are about to discuss next can be done for you using the DWA database. But before you take the shortcut, you need to understand exactly how you would do this by hand if you had to. This is what will ultimately

iShares MSCI Malaysia Index Fund (EWM)	
Financials	30.26%
Industrial	13.60%
Telecommunications	13.57%
Consumer Cyclical	11.37%
Consumer Noncyclical	9.69%
Utilities	10.30%
Basic Materials	5.43%
Energy	3.75%
Healthcare	1.56%

iShares MSCI Brazil Index Fund (EWZ)	
Financials	24.70%
Energy	19.83%
Basic Materials	18.98%
Consumer Noncyclical	13.92%
Utilities	6.61%
Industrial	4.53%
Consumer Noncyclical	4.45%
Telecommunications	3.11%
Technology	2.03%
Healthcare	1.09%

iShares MSCI Spain Index Fund (EWP)	
Financials	41.97%
Telecommunications	16.74%
Utilities	13.03%
Industrial	10.10%
Consumer Cyclical	5.02%
Energy	4.87%
Technology	3.13%
Healthcare	1.95%
Consumer Noncyclical	1.68%
Basic Materials	0.85%

iShares MSCI Italy Index Fund (EWI)	
Energy	31.14%
Financial	29.02%
Utilities	18.16%
Industrial	9.71%
Consumer Cyclical	7.19%
Telecommunications	4.75%

*Weightings as of approximately 10/15/2012

FIGURE 10.2 Exchange-Traded Fund Evaluation: Sector Breakdown—EWM, EWZ, EWP, EWI

make you what I call a craftsman. This is the highest calling you can achieve in investing in my opinion. Okay, settle back into a comfortable chair and let's cover the nuts and bolts of evaluating ETF charts. One of the first and foremost means of evaluating an ETF is just to look at its trend chart. Just like a stock or any index, ETFs are plotted using intraday high and low prices. All of the same charting rules apply—columns of X's and O's alternate, at least three X's or O's in a column, and so on. The only real change for an ETF chart is that we most often use a smaller box size since ETFs are baskets of stocks and they tend to move a little slower than individual names. Once an ETF gets into the $70 range or higher, though, we find that often a 1-point-per-box chart, the default scale, works just fine. Again, one of the great things about the Smart Chart function at www.dorseywright.com is the ability to make the boxes any size you want to create a chart with the volatility you desire. In many cases, you can simply look at the chart to determine if the volatility is too high or low. If the volatility of the chart is too low, you will see few columns of X's and O's. This will suggest to you to lower the box size on our Smart Chart function, which will increase the volatility of the chart. It's kind of like pressing the accelerator pedal on a car or vice versa for a chart that seems to be jumping all around. You will intuitively know when to raise or lower the box size.

As we have outlined in previous chapters of this book, we take a top-down approach to investing. That is, we first evaluate the overall market to determine whether it is supporting higher prices. Or which team is on the field? If the offensive team is on the field, as dictated by the Bullish Percent, we will generally look to initiate long positions, as we are in a wealth accumulation mode. Conversely, if the defensive team is on the field, we will generally be employing plays that preserve wealth. Or, to look at it another way, a rising or falling tide generally carries all boats. This is a very important concept to embrace. When you think of the financial meltdown of 2008, you realize that good stocks and bad stocks went down in unison. There is nowhere to hide other than cash when the plug is pulled in the bathtub. Stocks, like water, swirl down the drain. Once we have determined our outlook on the overall market, then we will look to sectors for opportunities. We are now moving from the whole to its parts. Next, we go to our inventory. For more and more professionals and investors, a significant portion of that inventory is the ETF universe. When this book was last published (the third edition), there were around 275 listed ETFs. As I write this fourth edition, there are now in excess of 1,400 ETFs listed in the U.S., and there will still be more added before you actually read this book. With this vast number of ETFs you

now have access to every area or sector of the market you could possibly want. The final step of our game plan is to evaluate the individual security to be purchased using tools such as trend, chart pattern, and RS, and then use the Point and Figure charts to manage the trade. You need to determine from the beginning of a purchase what you will do if things go right and what you will do if things go wrong.

Let's take a look at an example of how an ETF might be selected for your portfolio. We'll paint a picture from history and outline the landscape in October 2011. The NYSE Bullish Percent was reversing up to X's from the 18 percent level to the 24 percent level. To me this is the "Promised Land." This is a market that is sold out, but the reversal into X's suggests demand is now coming back into the market and has overtaken supply. This always brings me back to my Economics 101 class at VCU. The reversal up into X's from 18 percent put the offensive team back on the field with good field position. Next, if we reviewed the sectors, one that had emerged at almost exactly the same time as the reversal in the NYSE Bullish Percent is the Building sector. The DWA Building sector reversed up to X's from 16 percent, what I would consider an optimum buy level. You can see the pieces of the puzzle falling into place. George Peppard used to say on the TV show *The A Team,* "I love it when a plan comes together." I never forgot that statement because it is exactly how one should go about investing. All in all, the technical indicators were suggesting offense for both the market and the Building sector. Now comes the time to evaluate whether to buy an individual name or the whole school of fish. A look at the Point and Figure chart of the iShares Dow Jones U.S. Home Construction (ITB; Figure 10.3), shows it gave a triple-top buy signal on late November 2011, violating the bearish resistance line at a price of $11.50. By August 2012, the ITB had moved to the $17.50 level, maintaining the uptrend it began in November 2011.

In planning any trade, we want to know what we will do if things go right and what we will do if things go wrong. So entering this trade, with the ITB at $17.50, we would want to use a violation of the bullish support line as our stop, which as you can see is $15.75. That is about a 10 percent risk on the position. Think of this for a second. What if you had 10 positions and you were stopped out on one of those positions for a 10 percent loss. In the overall portfolio of 10 positions, you lose only 1 percent. This kind of "back of the napkin" calculation is what makes for solid gains in a portfolio. If you lost on every position a theoretical 10 percent, you still have lost only 10 percent of your portfolio, and that is very manageable. Keep this theoretical 10-ETF portfolio in mind when you begin to construct your own

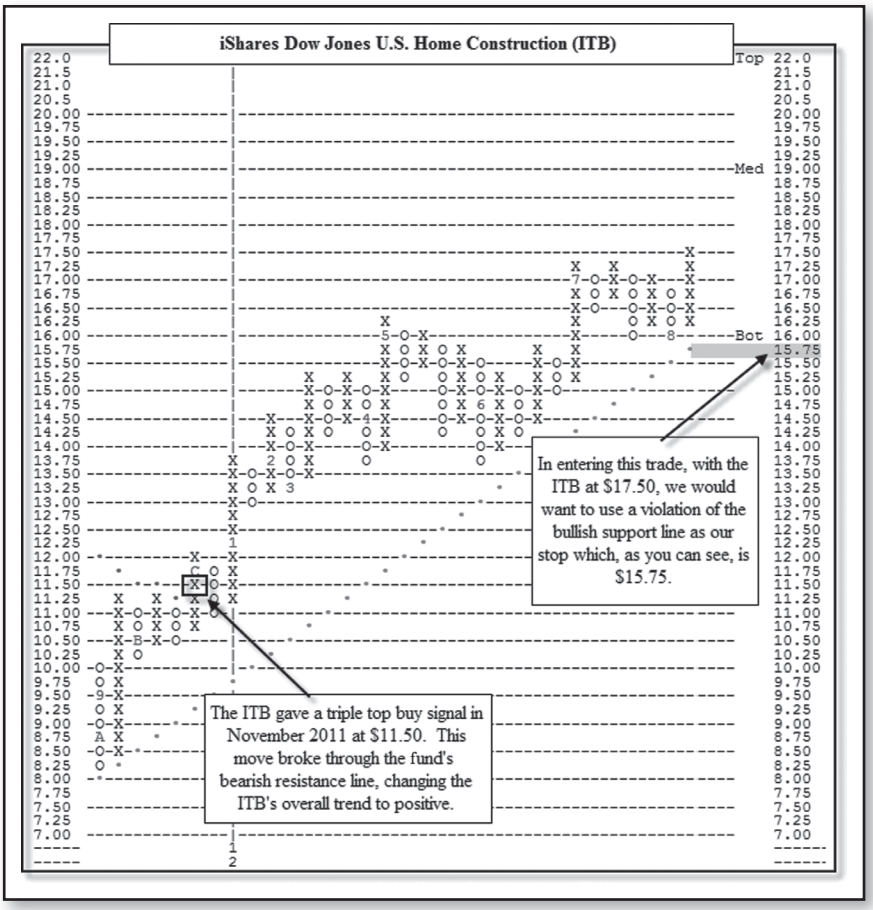


FIGURE 10.3 ETF Chart Evaluation: iShares Dow Jones Home Construction (ITB)

portfolios. Let me add something here, too. Technology has been relentless in forcing down commissions on trading. For example, at www.foliofn.com you can trade fractional shares through a window twice a day for free. You have to pay an annual fee to be a member of the brokerage platform, but that, in my opinion, is nominal. I have used them for over a decade and have had no problems at all. In fact, the CEO and founder is Steven Wallman, a former top Securities and Exchange Commission (SEC) official. I like that. What this means is that you can have a small amount of money and still own 10 positions or more. So let's get back to the trade. Your stop point, as I mentioned earlier, would be $15.75. The ITB remains above the support line, so there is nothing to do but hold it. I'll update the trade in the next edition of this book. Stay tuned.

Relative Strength

Now we get into the fun part of investing with ETFs. Pay close attention to this part of the book. Well, pay close attention to the whole book. Once you absorb it, you will be up with the top investors in the world. To me, this is the fun part, and this is the part where technology will help you the most. As you have gathered by now, RS is a very important tool in every aspect our work. It tells us where we should be and when we should be there. It smooths out the rough edges of the buy and sell signals and allows us to step back and see the big picture. When I think about RS, I recall the Zen story of an old man who accidentally falls into the river rapids leading to a high and dangerous waterfall. Onlookers feared for his life. Miraculously, he came out alive and unharmed downstream at the bottom of the falls. People were amazed he had lived and asked him how he managed to survive. The old man replied, "I accommodated myself to the water, not the water to me. Without thinking, I allowed myself to be shaped by it. Plunging into the swirl, I came out with the swirl. This is how I survived." And so it is how you should allow yourself to accommodate to the market, not the other way around. This is where using only fundamentals can have a devastating effect on your portfolio. Never, ever forget—the only force that affects price change is the irrefutable law of supply and demand. The fact that some analyst says something should happen does not mean it will. Remember, Apple, Inc. was laid to rest, pronounced dead by the brilliant market reporters in 2000. According to them, there was no chance for the company.

If we just let the market tell us what it is doing and we adapt ourselves, we'll come out fine. Remember the Zen story when you find yourself subscribing to newsletters. When we try to make the market accommodate us, that's when the trouble begins. This is probably where the old Wall Street adage, "The market can remain irrational much longer than we can remain solvent," comes from. In March 2010, a person considered a foremost expert on interest rates recommended selling Treasuries, as rates were going to rise. Here it is July 2012 and rates just hit a new low. Anyone following that fundamental recommendation was wiped out or at a minimum was on the exact wrong side of the trade. I only wish this person had a Point and Figure chart to consult before he made such a broad statement. He would have never done it.

Let's take a trip down memory lane. Thinking back to 2000 in the equity markets, large-cap stocks were all the rage. It's where all the money flowing into funds was going. But those well versed in reading the tides and

currents of the river (Point and Figure indicators) knew that in February 2000 the small-cap stocks moved back into favor. Instead of trying to fight the current, go with it and change where you are investing. This was a major event, and events like this happen only every few years. It's not an overnight change. Since that change, to this date the S&P Small Cap 600 (SML) is up 129 percent, while the S&P 500 (SPX) is down 3 percent. There are ETFs available for both the small-cap and large-cap universe of stocks from a variety of different ETF providers. I once coined the phrase "never anticipate the anticipators." Never forget this. Wall Street research is famous for anticipating the anticipators, not to mention the news media. Avoid them both.

The same RS calculations that we perform on stocks and indexes can be applied to all ETFs, helping us to determine when the tide is coming in and when it is going out. Again, there are a couple of distinctions with an RS chart of an ETF. With an RS chart of an ETF, we look most closely at the column of the RS rather than the signals because these are baskets of stocks and move a bit slower than an individual name. An individual stock can move around, maneuvering in and out of traffic like a sports car, while an ETF will keep moving with the traffic, like a big semi truck. But keep in mind that some ETFs move faster than others. This is where the craft comes in for you to determine which chart best suits your situation. As an example, let's take a look at the RS chart for the Vanguard Utilities ETF (VPU). Remember that when we are talking about RS charts for ETFs, instead of having the S&P 500 Equal Weighted Index (SPXEWI) as the divisor, we use the Dow Jones Total Market Index that trades as an ETF itself under the symbol IYY. On the VPU's RS chart we see that there are four columns going back to May 2000. The RS charts of ETFs are designed to capture major trends and not each wiggle in a sector. However, even the trader will want to be aware of RS, as the largest magnitude of movement usually comes from those areas with the best RS. But back to our chart of the VPU; let's examine each of these column changes in a bit more detail in Figure 10.4. The first column we see is a column of X's that began on May 26, 2000. As long as this RS chart was in a column of X's, it suggested that we have an overweighted exposure to the Utilities sector of the market. That column of X's continued a little over a year to a top on July 24, 2001, and during that period the VPU eked out a slight gain of 1.18 percent, compared to the iShares Dow Jones Total Market Index (IYY), which was down 14.14 percent over that same period. The second column, a column of O's that started on July 24, 2001, suggested a defensive posture on the Utilities sector. That column of O's continued until the reversal back into X's on October 25, 2004, resulting

VPU Relative Strength Chart

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186.2162 | | | |
174.8509 | | | |
164.1792 | | | |
154.1589 | | | |
144.7501 4 | B |
135.9156 3 O 7 O
127.6203 C O 1 O
119.8313 A 7 3 9
112.5176 X B 6 B
105.6504 9 O X 1
99.2022  5 7 X |
93.1476  X A X |
87.4626  X O | |
82.1245  | | | |
77.1122  | | | |
72.4058  | | | |
67.9867  | | | |
63.8372  | | | |
59.9411  | | | |
-------- 0 0 0 0
-------- 0 2 4 9
-------- /   / /
-------- 0   0 1
-------- 1   8 1
```

Date	Column	VPU	IYY
May 26, 2000 to Jul. 24, 2001	X	1.18%	-14.14%
Jul. 24, 2001 to Oct. 25, 2004	O	-13.27%	-3.42%
Oct. 25, 2004 to Sept. 8, 2009	X	10.09%	-2.45%
Sept. 8, 2009 to Jul. 15, 2012	O	30.88%	33.35%

FIGURE 10.4 ETF Relative Strength: VPU Relative Strength Chart and Performance

in a loss of 13.27 percent, while the IYY was down just 3.42 percent. The October 2004 reversal up versus the IYY was a signal to avoid IYY and buy VPU if these were the only two ETFs in your portfolio. This column of X's lasted until September 2009, and the returns were as follows: VPU was up 10.09 percent and the IYY was down 2.45 percent. Finally, in September 2009, the VPU's RS chart reversed back into a column of O's, signaling us one more time to avoid the VPU relative to the IYY. The RS chart continues on in a column of O's at this writing and thus far the returns for the VPU and the IYY are 30.88 percent and 33.35 percent, respectively. No fees or dividends included. The VPU is performing just slightly worse than our benchmark. When an RS chart reverses into O's, it doesn't mean the sector has to fall off a cliff and decline significantly. In fact, most often the sector does just what the VPU has done since its most recent column change—it underperforms slightly. But why would you want to be overweighted in a sector that has a high probability of slightly or even significantly underperforming? As long as this RS chart is in a column of O's it suggests that we have an underweighted exposure to the utilities area of the market versus owning the broad market only.

It is of the utmost importance to be in the right sector at the right time. For this reason, we run a number of different sector rotation models, using funds from a number of different ETF providers. Like I said before, sectors rotate in and out of season just like produce in the supermarket. We try not

to buy winter squash in the summer and summer squash in the winter. It helps to go back in time to see how our sector rotation models performed in difficult times. One of the most instructive times is the during the technology/dot-com company meltdown in the early 2000s. Most investors lacked a sell discipline in their portfolios because they bought into the technology boom hook, line, and sinker. Most investors were also overweighted in these stocks, meaning their whole portfolio consisted of these types of stocks. In March 2000, the iShares Sector Rotation Model was 100 percent invested in technology ETFs—the iShares Dow Jones Technology Sector (IYW), iShares Dow Jones Internet Sector (IYV), and the iShares Dow Jones Telecom Sector (IYZ). Over the next two months, the portfolio completely transformed itself. The first to come out was the IYV, which had been in the portfolio since August 3, 1999. Then the financial and chemical sectors moved into the portfolio as their RS charts reversed up. Next, we saw the IYW come out of the portfolio on April 14, 2000, after having been in the portfolio since September 25, 1998. The IYW as up 188 percent from the time it came into the portfolio to the time it came out. Then, two weeks later the IYZ's RS chart reversed down into O's removing it from the portfolio. Over the following two-week period, sectors like Utilities, Real Estate, Financials, and Healthcare were rotated into the portfolio. By May 2000, the portfolio had a 0 percent weighting in technology. This sector model is managed differently than the matrix concept underlying the international model below. In general, when a sector is in a column of X's on its relative strength chart versus the IYY, it is included in the portfolio. Conversely, when a sector reverses into O's on its relative strength chart, it is taken out of the portfolio. iShares sponsors DWA to update this strategy, among others, each week on our professional web site. You can clearly see what a powerful tool you have in RS and the virtually endless possibilities of how you can take this concept and create a managed portfolio strategy around it. And, you know, keeping it simple is usually best. There is nothing complicated about this strategy. Could you do things to optimize the portfolio? Sure. But just a straightforward approach like this can help keep the odds of success in your.

Advanced ETF Relative Strength

The RS concept is so transferable, the comparisons you can do are almost unlimited, but I wanted to give you an idea of some of the ones we find especially helpful by first taking a look at the international markets. As we pointed out in Chapter 5, one can do an RS chart of the broad international markets

to the U.S. markets to help determine "where in the world" you want to invest. But just as we do more in-depth analysis of the U.S. markets, we can also do the same for international markets. There are currently over 330 international ETFs listed on the U.S. exchanges and trading in U.S. dollars. On the international area of our web site, you'll also find a complete list of all the international ETFs denominated in euros, but we'll stick to the international ETFs listed on the U.S. exchanges for the purposes of this example. I highly recommend that you get to know these international ETFs because this broadens your horizons by allowing you to invest globally. With today's Internet, you can trade in any country you wish. I currently have accounts open for online trading in Indonesia, Portugal, and Australia. My account at www.DIF.pt (change the language to English) allows me to trade 40 different countries from one location and all ETFs from this location, whether they are international or domestic. I hold bonds as collateral for the account simply as an added safety factor, but over the years I have not really seen a real need for this. It is the best trading platform I have seen, and you can execute our international models on the site automatically even if you are an individual investor. Generally, our models are utilized by professionals, who then invest in them on individual investors' behalf; however, individual investors can also subscribe to them if they choose. So let's say that you've done an RS chart of the U.S. markets versus a broad international index like the MSCI EAFE Index, and it suggests that the international markets are favored over the U.S. markets. Okay, now what? Throughout the world, some areas are going to be stronger than others, and the best way we've seen to determine the strength across the entire globe is through a simple RS chart.

Figure 10.5 is a comparison of the iShares Latin America 40 Index (ILF) to the iShares MSCI Malaysia (EWM). When this chart is on a buy signal, it suggests that the ILF should outperform the EWM. Conversely, if this chart is on a sell signal, it would suggest that we would want to own Malaysia over Latin America. The RS chart of the ILF versus the EWM moved to a sell signal on June 10, 2011, and remains there to this date in July 2012. This sell signal told us that between the two funds, EWM was more likely to outperform in the long term, and the returns thus far have confirmed this signal. Since June 10, 2011, the EWM has outperformed the ILF posting a gain of about 1 percent compared to the ILF's loss of 14 percent. That being said, I want you to look at the chart. Remember that with ETFs we look most closely at the column of the RS chart rather than the signal because these are baskets of stocks and move a bit slower than a stock. Here is where judgment comes into play. Notice the long column of X's rising from 337 to 449.

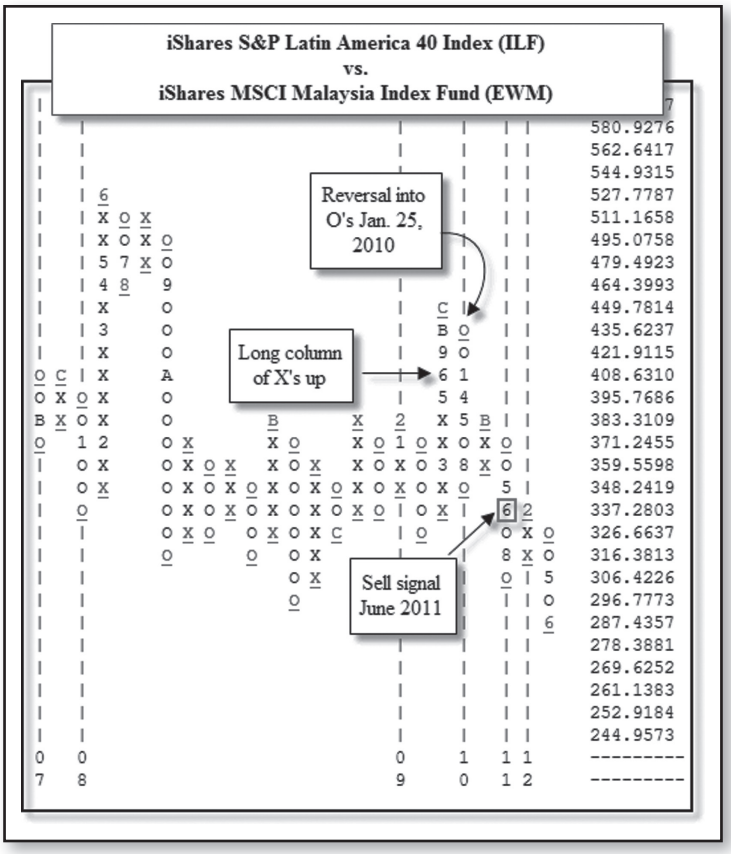

FIGURE 10.5 ETF Advanced Relative Strength: ILF vs. EWM

From the December 2009 top at 449, the RS chart would have had to exceed a previous bottom at 316 in order for the RS chart to give a sell signal. A move of this magnitude would be much too far to take action on. So when you see reversals from long columns of X's up or O's down, it is generally advised that you take that signal as a buy or sell signal. So moving back into a column of O's on this chart in late January 2010 suggested that you go long Malaysia over Latin America. If the chart reversed back to X's without having first exceeded a previous bottom, I would seriously consider switching my position. This may seem contrary to waiting for the actual buy or sell signals to take place, but RS charts are long term in nature and move very slowly relative to a stock's trend chart. This is where judgment comes into play, and this is why becoming a craftsman first before you allow technology to do the heavy lifting is all important. During this period from January 25, 2010, to present, Latin America is down almost 4 percent while Malaysia is

up 38 percent. The charts were right on. You can compare almost anything on an RS chart, and it's a great help to set alerts for these comparisons. The DWA System will do them for you each night and report on its findings.

Taking this concept a step further, we can construct a DWA world matrix (Figure 10.6) to give us a snapshot of strength within the international markets. This matrix is essentially the culmination of a large arm-wrestling tournament. In our tournament, every international country arm "wrestles" another country until every country has been wrestled. To determine the winner of the tournament, we merely count up the "wins" or RS buy signals for each country and then rank the countries with the one with the most wins at the top of the matrix. With about 52 international ETFs in the matrix, you want to focus your investments in those that are outperforming at least half of the total universe.

Employing a strategy similar to the world matrix concept described above, DWA has created a number of international ETF model portfolios. Utilizing a universe of the MSCI iShares Country ETFs, we created what we call the iShares International Model. This model has a good cross-section of developed countries as well as emerging countries. It is a hybrid of the fast and the slow.

Rank	Ticker	Buys	Xs	Tech Attrib/ Score	EWZ	FXI	EEB	RSX	EPI	PMNA	EWO	EWJ	EWI	ITF	MES	GUR
1	EGPT	50	45	4.93	BX	BO	BX	BX	BO	BX	BX	BX	BX	BX	BX	BX
2	GREK	48	51	4.87	BX	BX	BX	BX	BX	BX	BX	BX	BX	SX	BX	BX
3	EWW	47	37	4.77	BX	BX	BX	BO	BX	BX	BO	BX	BO	BX	BX	BO
4	THD	46	33	5.92	BX	BO	BX	BO	BO	BX	BO	BX	BO	BX	BX	BO
5	EPU	45	16	3.63	BO	BX	BX	BO	BO	BO	BO	BX	BO	BX	BX	BO
6	RSP	44	31	5.09	BX											
7	IYY	43	32	3.31	BX											
8	GXG	43	16	3.92	BX											
9	TUR	42	47	4.93	BX											
10	EWM	40	22	3.46	BX											
11	EWS	38	33	3.98	BX											
12	EWL	37	31	3.34	BX											
13	EWD	36	31	2.49	BX	BO	BX	BX	BO	BX	BO	BX	BO	BX	BX	BO
14	EWA	34	30	3.03	BX	BX	BX	BO	BX	BX	BO	BX	BO	BX	BX	BO
15	EWY	34	26	2.79	BX	BO	BX	BO	BO	SX	BO	SX	BO	BX	BX	BO
16	EWP	32	45	3.76	BX	BO	BX	BX	SO	BX	BX	SX	BO	BX	BO	SX
17	EWH	32	36	4.03	BX	BX	BX	BX	BO	BX	BX	BX	BX	BX	BX	BO
18	EPP	32	31	3.27	BX	BX	BX	BX	BO	BX	BO	SX	BO	BX	BX	BX
19	EZA	28	6	0.40	BO	BO	BX	BO	BO	BO	BO	BX	BO	BX	SO	BO
20	EWC	27	20	2.88	BX	BO	BX	BO	BO	SX	BX	BX	BO	BX	BX	BO
21	IDX	26	19	3.15	BX	SX	BX	BO	SO	BX	BO	BX	BO	BX	BX	SO

How to Read the Matrix:
EGPT is "arm wrestling" the other international ETFs listed across the top. For each "win" a 'B' is placed in the box. A final tally is made and listed under the Buys column. The ETF with the most buys is ranked #1.

FIGURE 10.6 ETF Advanced Relative Strength: World RS Matrix

This model is managed on a matrix format. The potential inventory for this model consists of over 40 country ETFs, and we use the matrix to compare and contrast their RS charts. This way, we can rank the countries from best relative strength versus the total to the weakest relative strength versus the total. The only time the portfolio is rebalanced is when there is a change in RS. On the matrix, when a country drops to a certain level, it is then taken out of the Model and replaced with the next strongest country. We wanted the *market* to tell us when to rebalance the portfolio, not just a calendar date. The portfolio remains unchanged until there is a fall in RS ranking. The time frame is of no consequence. Changes are made when they need to be made. Over an almost 12-year test period, this portfolio has outperformed the broad market averages nicely. Since the Model began trading in October 2005, the portfolio is up over 30 percent, the Dow Jones Total Market Index (IYY) is up 19 percent, and the SPX is up about 15 percent. This portfolio is my preferred way to invest in countries when you prefer to keep your money inside the United States. When I construct a portfolio, the country rotation allocation of the portfolio is generally comprised of our iShares International Model. Here's why. I know comparing RS is the best way to find the strength in a group of investment vehicles you are considering investing in. The portfolio runs itself. When a change takes place, you are notified. You then simply execute those changes. It is exactly what I would be doing by hand, but I don't have time to do it by hand, so the computer does it for me. This is the future. Embrace it.

The international model, like the world matrix strategy discussed earlier, is designed to point out RS across the world, and does not take into account absolute price declines. In other words, if the market goes down, this portfolio will likely move lower, too, but should outperform over the long term on a relative basis. In markets like 2008, we found that the high-RS international ETFs were extremely volatile. We ended 2007 up 26 percent for the year. The decline in the world markets was so severe we lost 51 percent in 2008; that year was a total killer for emerging markets. I need to preface this with our directive to our clients January 4, 2008, to get out of all international stocks. That said, we simply cannot stop trading the model. It must run in any market condition. It's the only way to have a track record. Once the markets stabilized, we shot back up 45 percent in the model in 2009. I'm sure, however, that anyone still in it at the end of 2008, if they did not take our advice to avoid all international stocks, had to have nerves of steel. Over $13 trillion of equity was lost in the U.S. markets during that time, and 5 trillion is still unaccounted for. Wonder why investors are still not willing to enter the markets and it's now 2013. It was said that the market

of 2008 rivaled the equity lost in the great crash of 1929, but that is not the whole story. When you take world equities into consideration, the losses were unmatched in history. I worry about the next recession/depression, which is likely to be worse as our debt worldwide has increased significantly. Don't let me digress on economics, my passion. This book is not about that. Not only the international markets were killers of equity, the U.S. markets were just as volatile. When the plug is pulled on the world markets, there is nowhere to hide. By 2009, the market had hit a bottom, and interestingly enough it was not the high-RS stocks that rebounded first. It was the low-RS stocks that rebounded first. Stocks like Citigroup that dropped to single digits in March 2009 were the first to gain sponsorship and rally off the bottom. High RS came along later in 2009 but accelerated past the junk that was the first out of the blocks.

Yet another way to analyze the ETF market is versus the mutual fund market. In any given year, over 80 percent of mutual fund managers do not outperform the S&P 500. If that is the case, why should you pay for active management of that fund when you could purchase an ETF for a much lower expense ratio? There are fund managers that can and do outperform their benchmarks, and the extra fee is well worth it. However, those managers that outperform the indexes change from year to year. A broad observation about this type of outperformance is that when the benchmark—small caps, growth, value, and so on—is a leading asset class, it is harder for the active manager to outperform his or her benchmark and you're probably better off with an unmanaged ETF. The reverse is also true—when the benchmark is an underperformer to most asset classes, there is a greater likelihood you can find a manager who is in fact adding value. Let's look at an example of how you can use the RS tools to determine whether the active manager is worth the fee.

American Growth Fund (AMRGX) invests with a domestic growth style, so we would want to do an RS chart of AMRGX versus a domestic growth ETF like the iShares S&P 500 Growth Index Fund (IVW). If the RS chart were on a buy signal, it would tell us that the manager(s) of AMRGX were adding value over the index. If the RS chart were on a sell signal, though, it would tell us that we would be better off in the index itself. This particular RS chart (Figure 10.7) has been on a sell signal for over a decade, suggesting that the IVW was the better play. Let's just go to the last column of O's, which happened on August 9, 2010. Now catch this: the returns are on a straight price performance basis through July 2012, American Growth Fund returned 8.65 percent versus 29.36 percent for the IVW. The RS chart pointed you in the right direction.

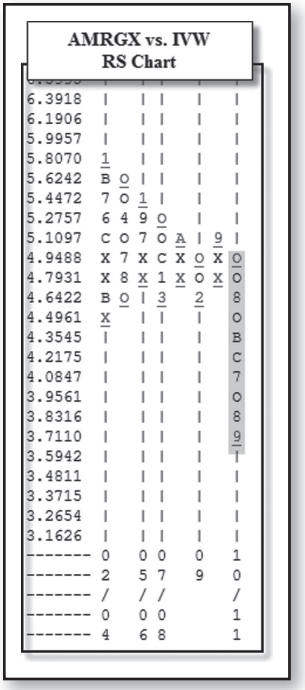

FIGURE 10.7 Mutual Funds vs. ETFs: AMRGX vs. IVW

If I wanted to invest in a large-cap growth fund that had a higher probability of outperforming the IVW, I might look at something like the American Funds New Economy (ANEFX). This RS chart moved to a buy signal on August 19, 2003 (see Figure 10.8). So let's say that we like the American Funds family and we decided to work from this inventory. Prior to August 19, 2003, instead of purchasing the New Economy Fund, we were instead using the IVW for our domestic growth exposure. Once that RS chart moved to a buy signal, we would call up the New Economy fund from the farm team and substitute him on the field for the IVW, essentially putting IVW on the bench. By making that simple substitution on our mutual fund team, we enhanced our performance tremendously—the ANEFX is up 84 percent through July 2012 compared to the IVW's being up only 48 percent over that same period. This is so interesting. I get goose bumps every time I think about the concepts we have created. DWA is all about adding value to the investment process and we have come a long way with our RS work. The world is changing rapidly and we're changing right along with it.

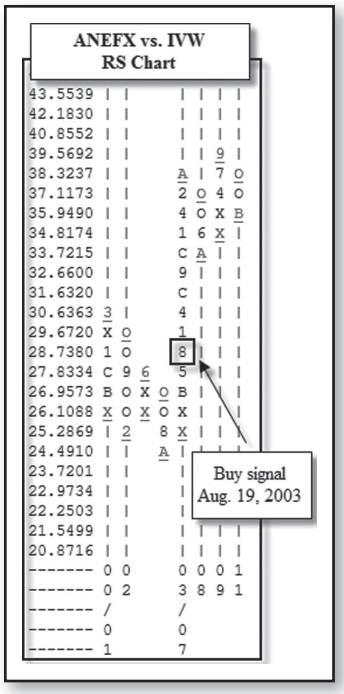

FIGURE 10.8 Mutual Funds vs. ETFs: ANEFX vs. IVW

Here's another example in the small-cap growth area. As we have outlined before in this book, the small-cap area of the market has been the place to be since February 2000. Now, in 2012, it's still the place to be. In fact, we just came out with our PowerShares DWA SmallCap Technical Leaders Portfolio ETF (DWAS). Over the past 12 years, small-cap mutual funds have been emerging and falling against their peer benchmark in the area, the iShares S&P Small-Cap 600 Growth Index Fund (IJT). On September 4, 2004, the Wasatch Small Cap Growth Fund (WAAEX) gave a RS sell signal versus the IJT (Figure 10.9). It was not until January 30, 2009, that the chart reversed up from a long tail down. Remember, earlier I said this is where the judgment comes into play. I consider this reversal up a buy signal because in order to rise to the point where another top is exceeded, most of the move would be missed. I also have no problem switching right back around if the chart reverses up again. These RS charts are long term, so I'm not worried too much about whipsaws, but they do happen infrequently. This is life on Wall Street. Learn this and you will love it. From the WAAEX's sell signal in September 2004 to the point where it reversed into X's in late January 2009

the WAAEX was down almost 19 percent while the IJT was down about 13 percent. The relative strength chart was on target: the fund underperformed its benchmark. Now let's look at the period from January 2009 onward. Remember that in January 2009 the WAAEX reversed into X's from a long tail down. At this writing the WAAEX's RS chart has not given a buy signal; however, the chart has added a number of X's to the column it began in January 2009. To this writing (July 2012), the WAAEX has returned 130.62 percent, significantly outperforming the IJT, which is up 110.67 percent. I am continually amazed at the value this method of comparing RS brings. I've been doing this for decades and I'm still amazed. Okay, let's look at one more small-cap growth example (Figure 10.9). On February 26, 2009, the Janus Triton Fund (JATTX), a fund composed of equity securities of small and medium-sized companies with a focus on growth potential, moved to an RS buy signal versus its peer group. That told us to expect this fund to begin to outperform the IJT. The JATTX is still trading in a column

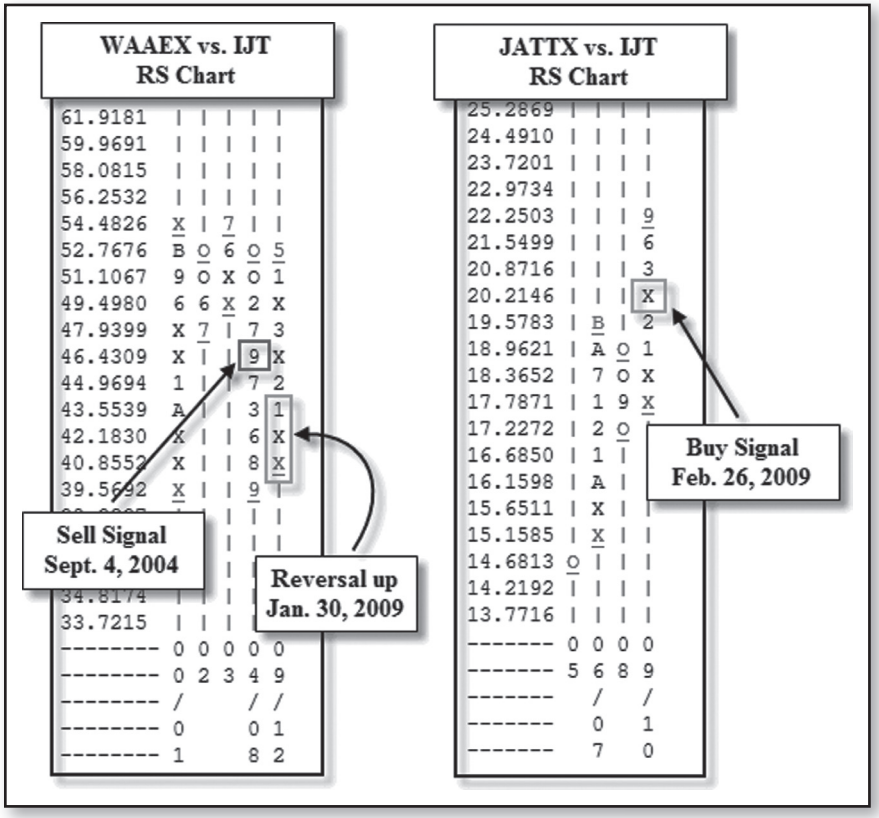

FIGURE 10.9 Mutual Funds vs. ETFs: WAAEX vs. IJT & JATTX vs. IJT

of X's on a buy signal. Since February 2009 both the JATTX and the IJT have performed well, posting triple-digit returns as of this writing. However, as the RS chart had indicated, the JATTX outperformed with a return of about 143 percent, compared to the IJT's return of 126 percent. That is over a 17 percent difference! Right call again.

The educational part of this seems like a lot of work. But it's as easy as pushing a button. Every chart you pull up on the DWA system has a peer RS button. Push it and the system will automatically do the calculation and present a chart in a second. If you want to mouse over tops and bottoms of columns for dates, just click for the DWA Smart Chart function, input the two funds you would like to compare, and it will create a chart that is interactive. You can also create your own RS comparison charts using the DWA Smart Chart feature. I can't image functioning in the market without this capability.

There is one more thing to remember about the DWA system's making life easy for you, and that's the ability to set action alerts on dozens of things. Say I wanted to be alerted on my cell phone when a particular RS chart changed direction. Just click the "Add Alert" button and the system will tell you how to add the alert. Then forget it until you are alerted.

What Does the Future Hold?

Where is the future of ETFs? We think it is only going to continue to expand. I saw this coming in 1982, and in my opinion we are only in the first foot of a 26-mile marathon. DWA will be in the forefront of this product as we were in 1983 when I went to Joseph Rizzello at the PHLX with the idea of securitizing their indexes and trading them instead of the options. ETF products really open a door to risk management for individual investors that previously was open only to institutes. Cash management takes on a whole new meaning now. In fact, it can now become a profit center. The ETF product is certainly a tremendous leap forward for our industry but it is the analysis of the product that will make the funds a viable addition to an investor's portfolio. Like investing in general, you must have an operating system firmly placed in your mind before any information about the investment process can be evaluated effectively. It is the analysis we do in the ETFs that makes them something that is truly special and one of the most useful investment tools one has today. With the Point and Figure methodology's robust, adaptive nature, you will be armed with the tools you need to evaluate

any ETFs on the market. For instance, we have developed 30 ETF models based on RS. These models are automatically managed by the DWA system and available to those who subscribe to our professional database. I use the models in my investment process. I find modeling is the easiest way to gain diversification. I have the portfolio managed by our RS methods and I do not have to think about it. All I have to do is select the various models I think fit my investment objectives and the system does the rest. You are the architect of your financial house, and the DWA system, working in partnership with you, will help maintain the house. At a minimum, take a free trial of our service and see how it works. I think you will be amazed and delighted, whether you are a hedge fund manager or an individual investor.

CHAPTER 11

Evaluating the Commodity Market for Opportunities*

October 19, 1987, was another typical Monday morning in which we prepared for the normal call volume of questions pertaining to which stock to buy, what sector to consider, and all the other typical questions professionals in the brokerage business mull over on such a typical Monday. The Dow Industrials had already shaken off 100 points or so the previous Friday, a material sum at the time, being the largest single-day point decline on record back then. This was about all we expected from the current correction, as this was the 1980s, after all. Frankly, by Monday morning our attention was shifting toward what to pick out of Friday's ashes. In fact, I bought call options on the OEX (S&P 100) Friday afternoon, expecting a nice snapback trade out of Monday's session. Of course, Monday morning didn't provide a

* Since the third edition of this book, we have published a book specifically on commodity investing: *Commodity Strategies: High-Profit Techniques for Investors and Traders* (Wiley Trading series). It is the most comprehensive book available on commodity investing using Point and Figure Analysis. Because of the availability of this book, I will shorten this chapter on commodities.

snapback—far from it. Instead, we watched in amazement as the Dow Jones Industrial Average fell 22 percent in one day. By the end of "Black Monday" there stood just one day in the Dow's long history that left more carnage in one day than did October 19, 1987, and certainly few were around that might have recalled the 24 percent drop in the Dow Jones on December 12, 1914. To put that fateful Monday into perspective, a 22 percent decline in the Dow Jones would equate to something along the lines of a 2,900-point drop in the market today. Can you imagine the field day the media would have with a number like that? But that was what a seemingly typical Monday produced in 1987, and somehow we survived to tell the story. Still, a recurrence of those events today would likely prompt the *New York Times* to lead with a title of "Chicken Little's Revenge."

That Monday changed many a life on Wall Street, and indeed it forever altered the course of Dorsey, Wright (DWA) as well. At the time we were, in essence, the only outsourced options strategy firm on Wall Street. When Watson and I started DWA, we had simply moved the Options Strategy Department I had developed and managed for Wheat First Securities down the street a few blocks. With the independence of having our own shop also came the necessity for recognizing the real force that such a rogue wave on Wall Street could have behind it. Following that fateful day in October, I knew the options business would never be the same again. A number of firms were already rumored to have gone under because of their own options exposure, and more would surely follow. Options would be the scapegoat for lousy risk management practices across Wall Street, and, right or wrong, this was simply the reality of the situation back then. We were small, but also nimble, and immediately decoupled options as the locomotive for DWA, replacing it with the Point and Figure Technical Analysis we had used for so many years as the backbone of our recommendations. This was our new long-term vision, but I also knew we needed a more immediate alternate source of income as this vision was pursued.

Commodities were a natural extension for us, and so I created a commodity report and sold it to Interstate Securities of Atlanta, Georgia, which had one of the best commodity departments on Wall Street at the time. The course correction from options to commodities is dramatic on the surface, but inherently meek at its heart. Commodity prices, like any derived from a free and open market, are governed by the irrefutable law of supply and demand. The imbalances between these two opposing forces are exactly what our work in Point and Figure charting records. I go to great lengths to view most things in both life and business in the most simplistic

of terms. Entire industries are made of complicating the simplistic, but often it is those who can see the simple for what it is, that can truly see the forest for the trees in this business and prosper from it. Copper is, quite simply, a hunk of metal. Cocoa is simply a bean that grows when cultivated in the proper conditions—most prolifically in the Ivory Coast—and from time to time will be looted by locusts. Sometimes the growing conditions will prevail, and at others it will be the locusts, but it's a bean nonetheless. Coffee is similarly nothing more than another type of bean, one in which Juan Valdez and others have made a living of producing down in Colombia. It need not be a great deal more complicated than that. By the same token, IBM is little more than a stock that moves about on the New York Stock Exchange, all the while its prices governed by supply-and-demand imbalances. What makes the movement of cocoa's price materially different from that of IBM's?

One could, in fact, offer that commodity markets are less cloaked in complexity than are shares of the typical common stock. There are no cocoa CEOs to be carried out of their offices in handcuffs for various improprieties. There are no likely claims of corporate malfeasance associated with the markets of live cattle. Be that as it may, in terms of what causes a change in price, there is no tangible difference between a share of IBM and a contract of coffee. IBM is to cocoa, as coffee is to copper, and so on. Certainly that is how a Point and Figure chart views the markets.

To the best of my memory, in 1987, I had never seen a soybean or a cocoa bean or, for that matter, a coffee bean that hadn't already been ground. However, when armed with the Point and Figure methodology, I was already an expert in observing their price movement and making sound financial decisions based on it. I knew that if there were more buyers than sellers willing to sell coffee, the price of coffee would rise. Conversely, if there were more sellers than buyers willing to buy coffee, the price would decline. If supply and demand for coffee was in perfect balance, the price would remain the same. There is nothing else to consider.

Still, as natural a transition as the commodity markets may have been for our research outfit, a commodity-centric report was destined to be the right product at the wrong time. Despite the crash of 1987, the stock market was in the middle of what would be a nearly 20-year bull market, while commodities were conversely amidst a 20-year bear market of their own. As such, the commodity report we had created didn't take off as we might have hoped; it was, quite simply, 13 years early. As William Peter Hamilton once said, "Wall Street's graveyards are filled with men who were right too soon."

The stock market recovered in late 1987 and quickly began to make up the ground it so quickly lost on "Black Monday." By year's end the Dow Jones was on its merry way higher, and commodities were back to being the black sheep of investing that they were prior to the crash in the stock market. Had we hung our hat on this single product, or any single product, for that matter, we would have ended up somewhere in that graveyard Mr. Hamilton referenced so long ago. The raw beauty of Point and Figure is that it is truly adaptive to any free market, and while the commodity business was primed to contract significantly over the next 13 years, the skill set of Point and Figure technical analysis that we had developed over so many years prior to starting DWA, proved its merit during a time of immense strain on Wall Street.

There was, however, one more act remaining in the commodity show before we allowed it to atrophy back in 1987. There was a hedge fund manager in Europe who was a client of ours on the equity side. I talked to him one day and suggested that his temperament was more suited to commodity trading. I offered him our commodity report at no cost so that he could get familiar with trading commodities on paper before venturing into the real world of platinum, pork bellies, and pound sterling. This began what would become a long and intriguing story at DWA, much of which I can only look back on and shake my head at decades later. It took this client about three months to become accustomed to commodities, and then one day I received a call from him saying, "Tommy, I'm ready." I replied, "Ready for what?" "Commodity trading," he offered unabashedly, and with that the rubber hit the road in no uncertain terms.

From that point forward I was called on to advise this large, very nimble, hedge fund on their commodity trading efforts. Besides the fact that I had only seen a coffee bean in its finished, ground state, I had never traded a commodity futures contract in my life. I had a disciplined methodology, a logical operating system, but very little else to fall back on at that time. What was about to follow would put every cell of discipline to its fullest of tests.

I set this client up with an introducing broker to clear trades through, and we were off and running. At this point it would be helpful to recall the last time you sat down to watch the Kentucky Derby. The horses are all in their respective gates, a bell rings, and the announcer offers the inevitable, "And they're off." That was us, as this hedge fund manager immediately flexed the intestinal fortitude of a gladiator. We began trading 500 lots in currency

futures, with a 500-contract position in something that would equate to 62 million euros' worth of leverage, in today's euro. At that time I either didn't or couldn't fully conceptualize the scope of these positions—it was simply colossal. It was along the lines of King Kong holding Ann Darrow in his hand, the commodity was King Kong and I was Ann Darrow. Come to think of it, I don't think we ever had a calculator that would quantify that amount of leverage we took on back then, so we just didn't get the full flavor of the risk we were taking. Today, I would break out into a cold sweat with a position that size, but back then we did it regularly and didn't flinch. At any one time, we could be long and short a combination of currencies totaling $250 million in value. Buying 600 gold contracts, or deutsche marks, or Japanese yen for this client became commonplace. Today, one gold contract, which controls 100 ounces of the metal, equates to $164,000 worth of exposure. Six hundred contracts just as easily creates $98 million in leverage. Still, this client didn't even breathe heavily with a position of this magnitude, and so eventually, unfathomably, neither did I.

While my experiences trading currency futures 500 lots at a time makes for a good story, the comfort I feel today in the commodity markets is far more a function of having that same logical, disciplined approach toward managing risk as I did during those harried times. I feel as comfortable trading commodities today as I do common stocks.I still couldn't pick out a cocoa bean from a police lineup, but I have been very successful trading them over the years nonetheless.

We would suggest that you familiarize yourself with some of the basics of commodity trading, such as hours of trading, contract sizes, and other environmental influences. All of this information is readily available on the Internet, much of it on our web site, or in other various commodity books. We won't rehash that work, but will rather focus specifically on why this asset class might add value to your investment game plan, and upon using the Point and Figure tools to develop a disciplined trading plan for commodities. We also won't focus on only futures contracts as the vehicle for commodity exposure, as there are many commodity-related exchange-traded funds (ETFs) that are present in today's markets outside that of strictly futures contracts. I think you will be both amazed and delighted to see the various instruments available to you in today's market. Anyone can make commodities a part of their investments today. Back in the day, you had to have a specific commodities account to trade them. It was for the very few, but not today. It's wide open.

Futures Contracts

It was in the 1840s that Chicago became a commercial center where farmers and dealers could meet to deal in "spot" grain. At the time, it was simple to exchange cash for immediate delivery of wheat. This was the point in time when railroads, telegraphs, and the McCormick reaper provided a confluence of both supply and widespread demand. The reaper led to exponentially greater wheat production, while the railroads and telegraph allowed farmers of the Midwest to sell their wheat to dealers, who then shipped it all over the country. Where previously the farmer was at the mercy of a city with very few storage facilities for such a supply of wheat and the limited availability of dealers (demand) standing ready to purchase his crop, the technology of the time allowed for both supply and demand to establish a more liquid equilibrium.

This liquidity allowed the futures contract to evolve toward essentially what we know it to be today: farmers (supply) and dealers (demand) committing to future exchanges of grain for cash. Then, as today, a farmer can agree with the dealer on a price to deliver to him 5,000 bushels of wheat at a point in the future, the end of December, for example. As with any free and open market, the price goes up and down depending on the supply-and-demand relationship of wheat, which could be influenced in the near term by any combination of weather, soil conditions, or disruptions to the transportation chain. On a longer-term basis, functions such as a change in the uses of a commodity, demographics, or even eating habits of the population can play into the supply-and-demand battle.

I remember the long-ago refrain on the commodities exchanges of "Beans in the Teens," which became almost a battle cry for a market in the 1980s that habitually fell short of reaching the "teens" on even its most fervent of rallies. In 2012, soybean futures rallied well into the "teens," with contracts trading at $17 per bushel as I write. Many factors came together to take prices to this historic level, like the confluence of two major rivers, a significant drought throughout the primary growing regions of the United States, and continued shifts in eating habits of some of the most populous countries in the world. We all watched as China grew into the second-largest economy in the world, and among the first change a more wealthy people makes is to increase their protein consumption. It takes roughly 7 pounds of grain to produce 1 pound of beef, and as the Chinese become a more affluent people, they are indeed eating more beef. China has imported increasingly larger quantities of soybeans, as have other emerging markets around the world,

and this supports the case that commodities are likely to be a place to invest for many years to come. At a minimum this is a trend to respect. While financial stocks enjoyed a generally great run beginning in 1982, commodities have returned far better since 2001.

Trading Futures Contracts

Let's begin with commodity-based futures contracts and the statement that they are first and foremost about trading, not investing. Most people (other than hedgers) trade commodities for the purpose of profiting from relatively short-term swings. They may do so directly in some cases, or by investing with a commodity trading advisor, or otherwise in a commodity pool. In the latter case, the commodity trading advisor, or commodity pool operator, does not truly "invest" in commodities either; he trades commodities for the purpose of profiting from relatively short-term swings himself. Why does this make a difference? Because the shorter your time horizon, the more critical it is to select the correct entry point, and the more important it is to pay attention to the technical characteristics (as opposed to the fundamental characteristics) of a stock or commodity. Always remember that following trends and near-term Point and Figure signals are imperative for those using futures contracts because both the leverage and the time horizon dictate this to be of paramount importance. But—and this is a big "but"—you can now escape the leverage of a futures contract through the use of the many exchange-traded products related to commodities. You can invest in one symbol that includes virtually all commodities. Or you may choose to buy an ETF that holds only agriculture commodities, or even one that provides soybean exposure exclusively. It is an amazing new world in 2013 where anything seems possible with regard to the construction of a portfolio. In my opinion, every investment game plan should incorporate the ability to use commodity exposure today.

Using Spot Charts

Spot refers to a cash market price for a physical commodity that is available for immediate delivery. The spot month is basically the futures contract that is closest to expiration and is also referred to as the "nearby delivery month," or simply "near-month" contract. A continuous chart uses the current nearby futures contract price data, continually rolling to the next near-month as the earlier one expires. The price of a futures contract at expiration, and

the cash or spot price of the underlying asset, must then be essentially the same as both prices refer to the same (physical) asset. By consulting a spot or continuous chart, you will be provided perspective as to what the longer-term trend of a given commodity is, thereby directing your overall trading posture. Spot charts are useful for establishing a posture on individual commodities, as well as commodities as an asset class, both of which we will examine in this chapter.

The spot or continuous charts are generally considered long term in nature. For instance, the NYMEX crude oil (CRUDE) chart reflects the spot price of West Texas Intermediate light sweet crude and has been a wild contract with which to participate. In 2008, it hit a high of $145 per barrel, traded as low as $34 per barrel in early 2009, and back to the century mark in 2012 (see Figure 11.1). Geopolitical events have often contributed to crude oil's being a volatile investment, but over the years we have found it very helpful to follow those long-term spot charts for gold, crude oil, and copper alike. These specific commodities all carry notable importance on an economic basis, so close monitoring of them can serve you in many ways. London Gold (UKGOLD) is a chart that we have been keeping since 1987,

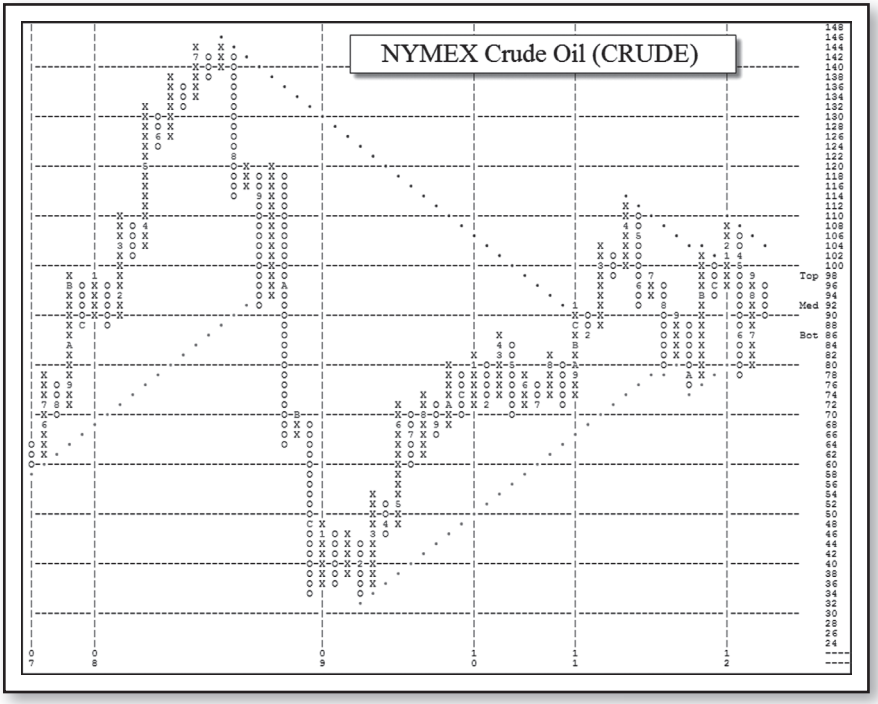

FIGURE 11.1 NYMEX Crude Oil P&F chart (CRUDE)

posting it by hand for many of those years. The chart is now available on our web site under the ticker UKGOLD. In essence, this chart is tracking the price of London Gold PM Fixing. High Grade Copper is another commodity market we tend to follow very closely. Copper, like gold or crude oil, is often considered a barometer of economic (industrial) health. I like to view both the spot chart and that of the particular contract I intend to trade before deciding on a posture. Both provide important perspective.

Trend Lines

Whether we are talking about shares of IBM or bushels of corn, one of the main premises of technical analysis is that prices tend to trend. Therefore, one of the main purposes of a chart is to help in the identification of the overall trend of a given vehicle—and to then play the direction of that trend for as long as it stays in force. Just like stocks, there are two main trend lines that are used: the bullish support line (BSL) and the bearish resistance line (BRL).

Bullish Support Line

- Also known as the uptrend line.
- Suggests the commodity is recording higher prices.
- Always a 45-degree line, which is upward-sloping to the right.
- In an overall uptrend, your trades should be limited to long positions.

Drawing this uptrend line is very easy—once the first buy signal is given, off the bottom or after a period of accumulation (moving sideways), you then go to the lowest-reaching column of O's in that pattern on the chart and begin drawing the trend line by placing a mark in the box directly beneath the lowest O. You then move up and over a box and place a second mark, and repeat this process, which will result in an upward-sloping 45-degree angled line—this is your bullish support line.

Bearish Resistance Line

- Also known as the downtrend line.
- Suggests the commodity is recording lower prices.
- Always a 135-degree line, which is downward-sloping to the right.
- In an overall downtrend, your trades should be limited to short positions.

As a general rule of thumb, if a commodity is trading above its bullish support line, in an overall uptrend, your trades should be limited to long positions. This rule is difficult to adhere to at times, such as when a commodity is well beneath the prevailing negative trend line. In these instances, a shorter-term trend line can allow you to fine-tune a position, which we will discuss a bit later, but your overall bias—long or short, will be determined by whether the commodity is trading above or below its trend line. A violation of the bullish support line, coupled with a sell signal (recall our discussion on chart patterns) on a commodity chart is quite simply a "call to action." It is a sign that you must change your current course of action with that particular commodity. Long positions, generally speaking, should be sold or some type of protective action should be taken; as well, short positions could then be considered. Once a commodity proves you are wrong in the direction of the trade, you can close it and execute an opposite trade going in the proper direction as dictated by the price action. By adapting your posture to the overall trend, you can let your winners run, staying with and catching a long-term trend. Or, more important, should a trend change, it allows you to cut your losses short. Over time, this is one of the keys to success in trading both stocks and commodities (see Figure 11.2).

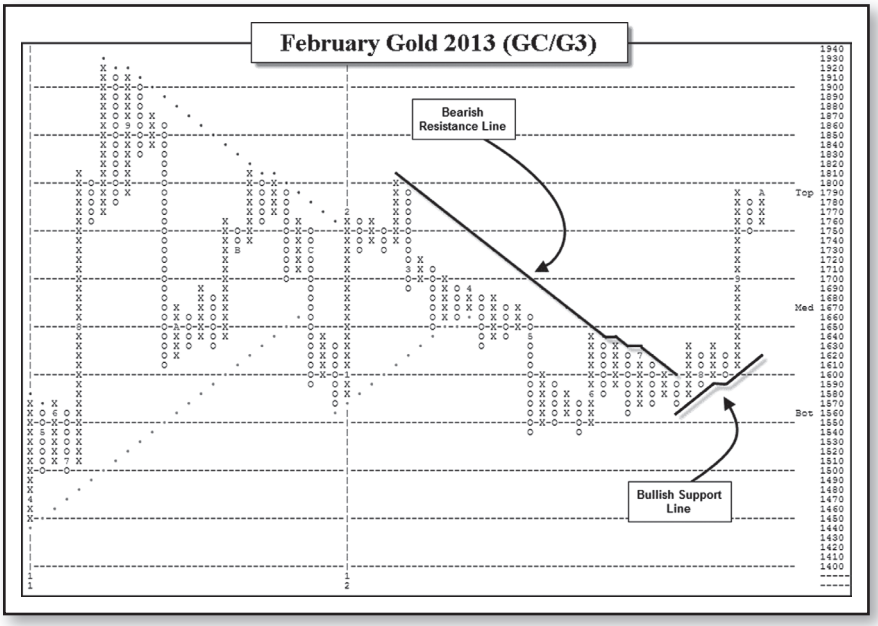

FIGURE 11.2 February Gold 2013 (GC/G3)

Notice that during the first half of 2012 Gold was below the bearish resistance line. This suggested that the only play to be had was that of being short gold. This was of course not consistent with what much of the mainstream financial media suggested at the time, or that of the many gold coin advertisers on AM radio these days. However, it was not until July 2012 that the February 2013 gold contract broke back through its bearish resistance line, at which point all shorts would be covered and long positions once again carry the day. The vertical price objective for gold upon that trend change was $1,760, a level it would test by September. I am a position trader, and want to hold for the full ride whenever possible. Often, I look back and wish I had taken small profits along the way, but that micromanagement of a trend tends not to pay off for me in the long run. When you catch a trend, and find the fortitude to stick with it; this is where the big money is there to be made. Day traders and the like tend to rely on a multitude of small gains here and there, but under those conditions it takes just one significant hit to the portfolio to wipe out a great many gains. On the contrary, managing losses in a systematic and disciplined manner will allow for those strong trends to carry a portfolio significantly higher over time. I'll leave day trading to others, as I much prefer relying on the trend-following tools of this methodology to keep me on the right side of the markets.

Chart Patterns

Chart patterns such as the basic double-top and double-bottom break, as well as more developed patterns like the triangle or catapult formation, were discussed in depth earlier in this book. These patterns are simply a record as to whether supply or demand is winning the latest battle in price, and they are as applicable to commodity trading as they are to stocks. Bullish patterns within a positive trend are a strong signal to be long a futures contract, and bearish patterns within a negative trend are strong signals to sell short a futures contract. Signals that are counter to the prevailing trend (buy signals within a bearish trend, or sell signals within a bullish trend) are most often used as stop loss points, which will be discussed shortly, but are rarely used to establish a new position. A sell signal that is given within a positive trend (counter trend) is typically a sign of consolidation or a pullback toward the next significant level of support, but not of a long-term change in direction. Such a condition is most likely to produce a move toward a previous bottoming area or long-term trend support, and can simply provide an opportunity to reenter the position at lower prices. When trading futures

contracts, focus on entering positions that are on buy signals and within a positive trend, or conversely shorting contacts that are on sell signals below trend. These are the situations that present the greatest probabilities for success in commodity trading.

A look at the December 2012 corn chart illustrates the fantastic ride that corn prices have produced over the past year. Massive gains were had by anyone willing to stay with the trend. That said, notice the lower tops being created within Figure 11.3, and the potential sell signal at 792. This would provide an important sell signal for those long this contract, as it comes after a lower top. This is the type of near-term signal that would be of great concern to me. If I were long corn, here I would use that sell signal as my stop-loss point and go back to the sidelines until such a time as I can see a new buy signal as a clear indication that the long-term trend has reasserted itself. Remember, the long term trend is still up, and so taking the short side of corn is not even a consideration, but if a near-term top is being placed, I'd prefer to step aside for a bit and wait for a better pitch to swing at down the road (see Figure 11.3).

Let's now take a closer look at how this contract could have been played using nothing more than the Point & Figure chart to guide you. You will go long on the change in trend at the bottom of the chart and would respect sell stops on any subsequent sell signal. In other words, you are long the contract until a sell signal is given, at which point you sell the contract and move back to the sidelines. You then take the next buy signal, so long as trend has remained bullish, becoming long once again with a new stop-loss point initiated and managed based on any sell signal that is given once long a position.

The initial long position is put on at $544 on a violation of the bearish resistance line. Let's discuss this for a moment as buying at $544 would also entail creating a stop-loss point on the next sell signal, which was initially at $504. This would have created exposure to a potentially significant loss, and so one "right answer" at the time would be to scale into the trade with partial positions or simply using limit orders to enter on a pullback (if it presented itself). Remember that you are probing for a trend. You might have started out with one contract, intending to increase the size on subsequent buy signals or pullbacks within the confines of the bullish signal that was in place. For the sake of this example, however, let's just say you bought one contract at $544. The next sell signal did not occur until $688, producing a gain of 144 points. At this point you would move to the sidelines until such a time as you receive the next buy signal. This next buy signal comes forth at $736, at which point you are long corn once again and will sell on the next

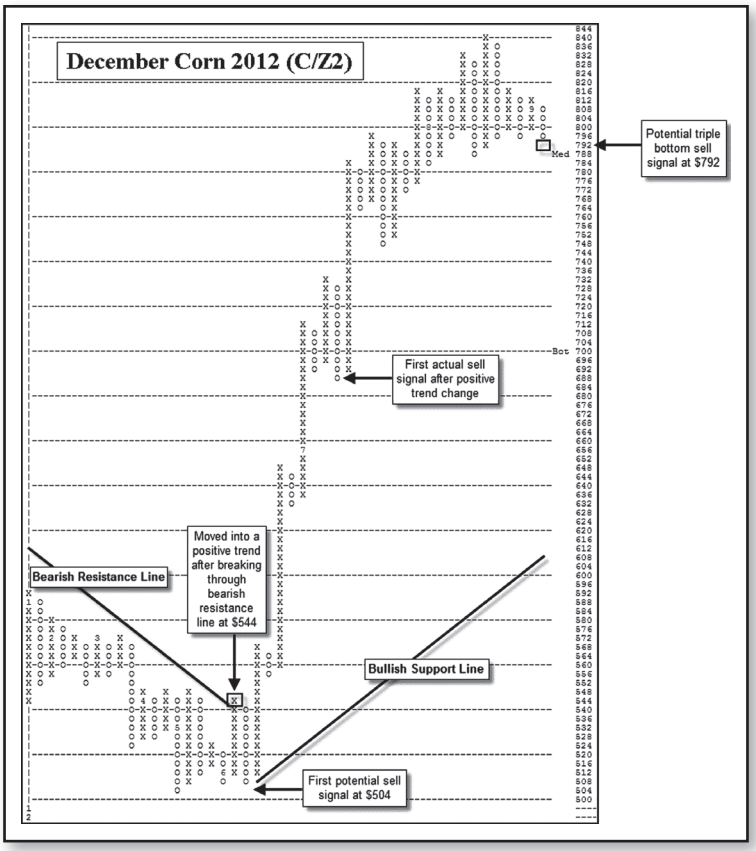

FIGURE 11.3 December Corn 2012 (C/Z2)

sell signal, no matter where it is. As the price action plays out, the next sell signal occurs at $760, which again produces a net gain, this time of 24 points. From here you remain on the sidelines until the next buy signal, which takes place at $796, and provides a stop-loss point of $768 upon entry. As the chart developed, the next sell signal actually took place at $792, producing a loss of 4 points. The uptrend, at this point, is still intact and you will once again stand ready to buy on the next positive signal, which comes at $836. So you are now long one contract waiting to see what happens next, managing your stop-loss point along the way. The December corn contract goes to print with the chart sitting at $796 and a potential sell signal looming at 792. Assuming the worst and that your stop is in fact hit, it creates a loss of 42 points.

Now net out the gains and losses and see where we stand: position 1, +144; position 2, +24; position 3, –4; and position 4, we'll assume a loss of –42. The net result of these four trades within one positive trend was +122

points. Those are outcomes that I'll take any day, and, as you can see, managing the trade was pretty straightforward so long as you stick with your discipline. This is a great example as to how the Point and Figure charting method can simplify your trading process. The buy and sell signals are definitive and easy to recognize. You may find it interesting to do this exercise on a number of contracts, first trading on paper to see how they play out and increase your comfort level. In the end, it's all finding a process that will help you remove as much emotion from the equation as possible.

Risk Management

Risk is basically the amount and probability or possibility of incurring a meaningful loss (of capital) or series of losses. There are several types of risk inherent to trading commodities:

Avoidable risk is that which can be reduced or eliminated without any reduction or compromise in reward. Examples of this type of risk would be trading an illiquid market and not properly diversifying your commodity portfolio. Illiquid markets can provide a great deal of slippage and bad fills on both sides of your trades (entry and exit). Diversification typically will serve to reduce risk.

Unavoidable risk is that which cannot be reduced or eliminated. In other words, there will always be some risk involved in trading commodities, stocks, or any investment, for that matter (given that there is an expected return or profit).

Controllable risk refers to risk that can be reduced or mitigated as a function of your entry and exit points. This will be dealt with in more detail later as we continue our discussion on stop-loss points and risk-reward evaluation.

As mentioned, with any investments, and in this case with commodity trading, there is risk involved. To a large extent, you can reduce or mitigate your risk with smart risk management techniques. Truly, over the long haul, it is proper risk management that will be the key to your success in commodity trading. You must always be aware of the risk you are taking on any given trade—the risk of loss. Being aware of your risk is important, and being able to define that risk is just as integral in our experience.

Stop-Loss Points

Stop-loss points are a key element of risk control. In our simple example with the December 2012 corn contract you can see how stop points

might be used within your trading program to both recognize and define the lion's share of risk you are taking. Recall our definition of risk—the probability of significant loss of capital. One of the best ways to provide a control mechanism on risk is through the use of a stop loss. That is why we always determine where we are getting out, in a worst-case scenario, before we even get into a trade. By consistently undergoing this process you are better able to determine if the risk is acceptable on any given trade. As a rule, you must know what you will do (and where you will do it) if things go wrong. At DWA, we must deem the risk to the stop (the potential loss) acceptable before we place the trade. But then once that trade is executed, our approach dictates that a stop order be placed GTC (good 'til canceled). This serves a couple of purposes. First, you don't have to constantly watch each tick of trading, for fear of missing your exit point. Second, it removes much of the emotion from the trade. Having a predetermined exit strategy (a GTC stop) can protect you from large losses because you can't procrastinate or rationalize staying in a losing trade that has negated your reasons for entering. Avoidance of severe losses, truly, is the key to success in any trading and the linchpin of risk management. Using a stop loss point reduces the possibility of a severe loss. There has been a great deal of research produced on the topic of trade management, and the results consistently find that a major return factor for successful trading programs is not the number of winning trades versus the number of losing trades, but rather the size of your winners versus the size of your losers. Having measures in place designed to cut losses short, while letting your winners run, is a recipe for trading success. This makes a strong case for trend-following systems, based on Point and Figure (PnF) analysis, as a necessity for commodity traders.

To that end, how do you know where to place stops using PnF? If the entry point is where risk is low and the potential reward high, then the exit point (stop loss) is where the risk is high and the potential reward low, or at least increasingly uncertain. This begs the question, where would risk be high and potential reward uncertain? Turning to the PnF chart, such conditions arise where the commodity will break a significant bottom or violate its trend line—basically, a point at which the chart suggests supply has won the battle, not necessarily the war, but at least the battle. This, therefore, suggests that you no longer want to be long the commodity on such a development.

In Figure 11.4, we provide you with two such stop loss examples. The main point to remember is that you should always have an exit strategy for

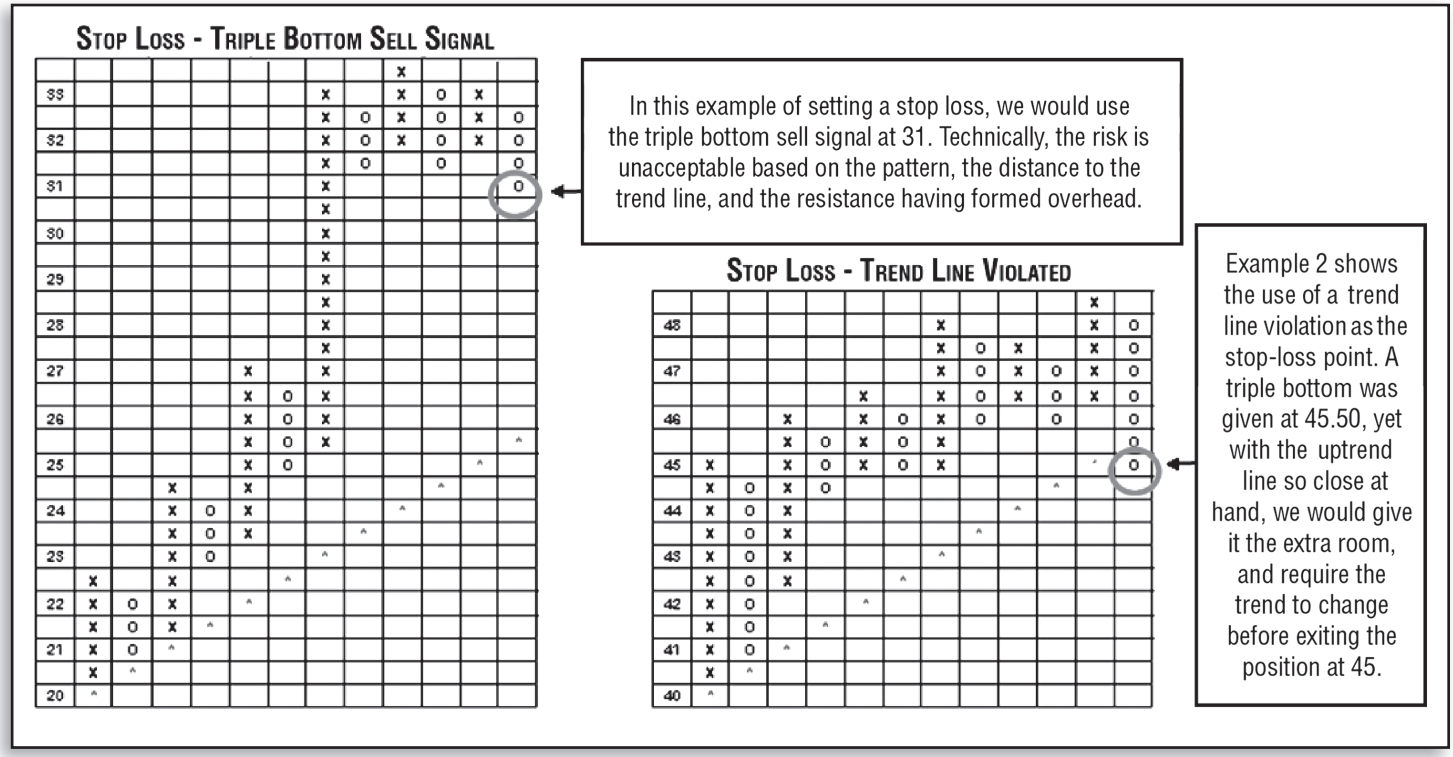

FIGURE 11.4 Setting Stop-Loss Points: Trend Stops versus Signal Stops

each and every trade you enter. The beauty of using the Point and Figure chart is the ease with which you can determine this exit point, or stop, and then the fact that you may design a trade with a defined risk level up front. In addition, the PnF chart allows you to raise (or lower) the stop as the chart unfolds. This serves to reduce risk further as price action develops in your favor, allowing you to protect a profitable trade and its related gains.

In general, sell signals given above trend suggest an increased probability of a meaningful breather for the commodity. Sell signals involving a violation of trend instead suggest that a structural change in the supply and demand relationship for that commodity has come to pass. In this sense, while a near-term sell signal within a positive trend may set up future reentry at lower prices, a violation of trend suggests that future trades in that commodity should be on the short side of the market.

Relative Strength with Commodities

We now turn our attention to the application of relative strength (RS) within the commodities realm. When interpreting an RS chart, there are two primary aspects to evaluate—the most recent signal given on the chart and the current column. In other words, was the last signal given on the RS chart a buy signal (a previous top broken) or a sell signal (a previous bottom broken)? Also, is the chart currently in a column of X's or a column of O's?

We first want to ascertain if the RS chart is on a buy or sell signal. This will demonstrate the long-term implications for the underlying commodity. If that last signal on the RS chart was a double top, the RS is said to be "positive"; if the last signal on the RS chart was a double bottom, then RS is "negative." Positive RS implies a trend of outperformance is in place, while negative RS suggests underperformance is the trend in force. In measuring RS on a shorter-term basis, we want to focus on which column the RS chart is in. If the current column is X's, the commodity is said to have positive RS on a short-term basis; if in O's, the short-term RS is negative. Ideally, you want to focus your buying within those commodities exhibiting positive RS, while avoiding or shorting those commodities that are exhibiting negative RS. As with stocks, the long-term RS signal carries more weight in our evaluation process. However, within the equity realm we most commonly employ RS charts that compare an individual stock against the S&P 500 Equal-Weighted Index. The DWA Continuous

Commodity Index (DWACOMMOD) is the closest counterpart among commodity-based indexes and is used as the primary benchmark for RS evaluation of individual commodity contracts. The strongest RS condition is that of the most recent signal versus DWACOMMOD being a buy signal and the current column being X's.

The key to consistent success is to initiate positions where the overwhelming weight of technical evidence is leaning in your favor. This entails using chart patterns, trend lines, spot and continuous chart evaluation, and RS analysis together in an effort to arrive at the best decisions for your commodity trading. You want to focus long exposure on strong trends, bullish patterns, and areas that are entrenched within trends of outperformance against the broader commodities market. Conversely, short exposure should be concentrated within areas exhibiting the opposite characteristics. In this manner, commodity traders stack the odds in their favor as much as possible.

Support and Resistance

Identifying known levels of support and resistance is also useful in trade management. "Support" is nothing more than a level where the commodity has tended to gain buying pressure, which significantly slows and eventually halts a decline. Conversely, "resistance" is a level at which a commodity loses buying momentum, allowing selling pressure to regain control of the price movement. As a rule of thumb, I want to scale into purchases on pullbacks close to support or scale into short sales on rallies to known resistance levels. This is, of course, providing that our macro analysis of trend, relative strength, chart patterns, and so on has already been completed to corroborate your overall posture (long or short).

The Live Cattle Continuous chart (Figure 11.5), is a good example of establishing resistance and later breaking out of that resistance. Notice how it operates below the bearish resistance line for much of 2012. In August, it begins to build a base, but on its early attempts to rally to the 120 level, it meets resistance and backs off. The 120 level, for whatever reason, acted as a brick wall, with the commodity faltering four times at that level. Finally, on its fifth attempt to move through 120, the overhead supply had dried up and the contract exceeded that level by one box. This was a compelling buy signal to take on this chart and a classic picture of the battle between supply and demand being waged over time. There is no way to know why the sellers were present at 120, but it is sufficient to simply know that this was a point

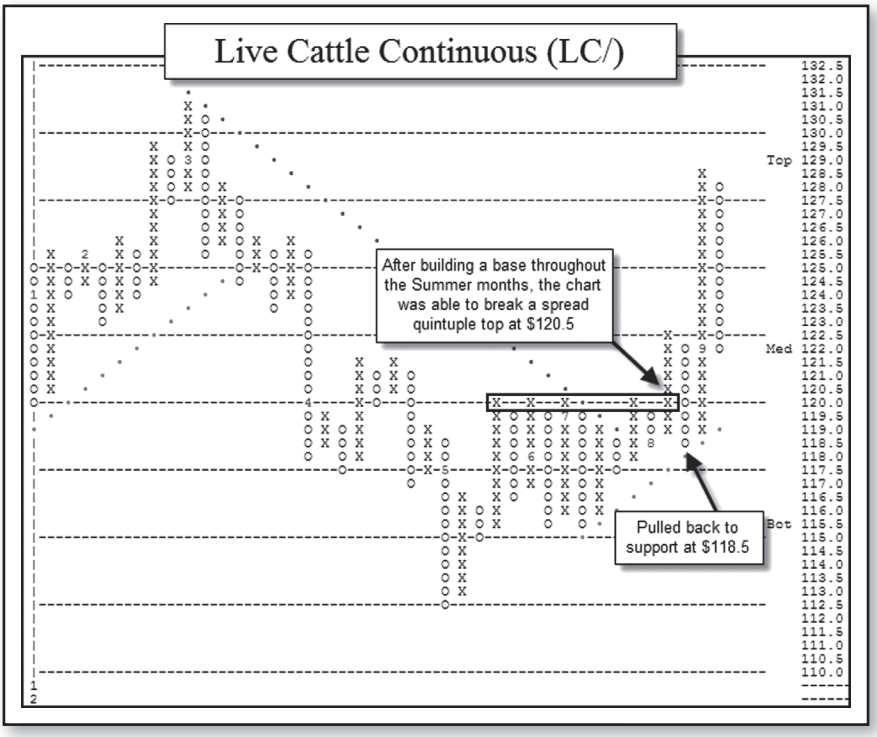

FIGURE 11.5 Live Cattle Continuous (LC/)

of contention in the battle. The greater that level is defended by sellers, the more we are apt to view that level as one that is strategic to market participants. When such a level is broken, we know that a psychological victory has been had by one side of the market, and this often proves important for traders.

This chart is meaningful to me, as I was long live cattle at this very point. The problem I had as everything was seemingly setting up perfectly for a great position trade is that I overleveraged the position. At times you will see an opportunity that looks almost too good to be true and your emotions encourage you to buy more contracts than you truly have the stomach to handle. This can be a killer, and it was for me in hindsight. Notice the pullback toward support that came with a column of O's from 122 to 118.5. That relatively innocuous exhale became painful in my totally overleveraged position, so much so that my delusions of grandeur changed quickly to despair. I sold out of live cattle at the exact bottom, largely so I could get to sleep at night. I became part of the exhausted supply, capitulating into the hands of buyers, and watched as live cattle found the support

it needed and reversed up. I booked a loss, went on about my business, and watched demand take hold of the cattle market once again. Naturally, I felt like banging my head against the closest wall, and can only hope that my own costly mistake can be an example that saves you from a similar experience.

This goes back to our earlier discussion of the varieties of risk. Overleveraging is very much an avoidable risk, it is something you have complete control of as you choose to enter a trade. I should have simply sized the position more appropriately, or at least deleveraged the position down to an acceptable level of risk once I recognized my initial error. The real mistake was evaluating the trade, deciding on a stop-loss point, but having a position that was too big for my stomach to truly accept the distance to my stop as palatable. These are things you need to think about before you put the position on, as leverage will be a killer if you allow it to be. And so this becomes my latest reminder that I'm human, too.

Writing this chapter forced me to go back to a chart that naturally turns my stomach to even think about. However, I decided to set an activity alert on our system, at which point I'll receive an e-mail and text message when this chart reverses back down again. I will consider at that point going long cattle once again, but this time with less leverage. There is an old saying in the stock market that applies to commodities as well: "Sell down to your sleeping level."

Price Objectives We discussed the concept of price objectives earlier in this book, and certainly they are no more a guarantee that a commodity will rise or fall a specific magnitude than they are for a stock. A price objective provides a measure of potential, and thus a guideline as to where prices may travel within the context of the current "signal." These price objectives provide a particularly useful perspective in ascertaining the potential reward versus the defined risk of a given trade. After seeing a significant technical breakout in one direction or the other, the strength of that breakout is used in combination with a determination of a stop-loss point in an effort to assess a risk-reward scenario for any trade. For any objective risk-reward analysis we need to both define the reward potential of a trade as well as the risk we are exposing ourselves to in any given position, and for this reason Point and Figure price objectives serve an important (if limited) role. The general approach is no different than it is with stocks, an example of which can be seen using the "horizontal" price objective for a futures contract, after witnessing a "big base breakout" on its chart.

Big Base Breakouts The premise of a horizontal price objective is that the size of the base dictates the size of the resulting potential out of the base. And so the bigger the base of consolidation is, the larger the price objective becomes when a breakout is confirmed. You would not want to be a buyer of a commodity when that commodity has rallied up to resistance, but instead you want to see it penetrate that key resistance. The only exception to this would be if you are merely trying to trade the "range" of a base—meaning you buy on the pullback to the bottom of the base (support), and expect to sell on the rally to overhead resistance (or the top of the base); such a posture would be considered more of a short-term trading tactic. Generally speaking, the greater upside potential is found upon seeing a commodity break through a major resistance level. The previous illustration of the Cattle Continuous chart serves to show a "big base breakout," and we can begin a calculation of our horizontal count by starting at the widest point in the formation, which in this case would be the column of X's that took the chart to $120 for the first time. This is the point at which the base began to form and at which the opposing forces of supply and demand were squarely matched for a period of time. I then count horizontally the number of columns encompassed by this pattern, to the point at which cattle finally broke free from this consolidation. The breakout took place at 120.5, and took place after 11 columns of back-and-forth action. I multiply that number, 11, by the box size of .5, which results in 5.5. I multiply that 5.5 figure by a bullish multiple of 3 to give me a projection of 16.5, which is simply added to the lowest level within that horizontal pattern. The bottom of the base in this case was 115.50, to which I add my projection of 16.5 to generate my horizontal price objective of 132.

We can also calculate a vertical price objective, which is generated from the first buy signal off the bottom. This objective is then based upon the double top buy signal at 119.50. That column finished its move at 120, the top of the column of X's, which we then use to create an alternate projection of the price potential for cattle. For a vertical objective we count the number of X's in the column generating the buy signal, which is 5 in this case, and multiply that number by the box size of 0.5. The figure of 2.5 is multiplied again by our bullish multiple of 3 to create a projection of 7.5. This projection is added to the bottom X in the column creating the buy signal, or 118 in the case of cattle. Our vertical price objective in this case is 125.5. So what do we do now with two different price objectives? As a rule, we take the lower (more conservative) of the two, and in either case its simple fourth-grade arithmetic.

Changing Box Size When analyzing a commodity on a technical basis, your primary tool is the actual trend chart of the commodity. Often, the commodity chart will progress in a very orderly fashion, showing a series of higher tops and higher bottoms (if in an uptrend), or a consistent series of lower tops and lower bottoms (if in a downtrend). But there are times when a commodity will experience a straight spike up (or down) in price, resulting in an extended condition with no apparent support (or resistance) at hand. This can be troublesome for a pair of reasons—no viable stop-loss point is apparent for managing risk, nor are any pullbacks shown to allow for potential new entries into the commodity.

This is where a change in box size can be useful. When necessary, reducing the box size on the chart can be a very helpful method to employ in order to gain insight as to levels of support and resistance, areas of consolidation, potential entry levels, and viable stop loss points. If the default box-sized chart appears orderly, use that chart. If the chart seems to be very slow in reacting to price change, however, generating only a few columns on the chart, it would make sense to lower the box size to speed up the chart. By the same token, if a default chart is chaotic in its development, producing an extremely choppy pattern, viewing a larger box size will have the effect of slowing the picture down and often producing something more orderly. It's very helpful to look at alternate box sizes in an effort to gain a little more perspective—it can only help.

Moving Beyond Trading

Commodity Market Indexes

There are four commodity market indexes that we turn to when evaluating the general picture for the commodities market. You may consider these to be the Dow Jones Industrial Average and S&P 500 of commodities. Similar to stock market indexes, each commodity market index is constructed a little differently. The one we have focused on the most over the years is what is now labeled the DWA Continuous Commodity Index (DWACOMMOD). This is an equal-weighted index of 17 commodities and is an index whose history is actually comprised of several indices over the years dating back to the 1950s. The CRB Futures Index was originally designed to reflect, in a dynamic fashion, the broad trends in overall commodity prices and to serve as a price measurement for macroeconomic analysis. In 2005, the Reuters/Jeffries CRB Index (CR/Y), considered the standard in the industry, made its tenth major revision since first being calculated by the Commodity

Research Bureau back in 1957. This revision, however, caused the index to move away from equal-weighting its components and instead began overweighting the more heavily produced raw materials. And so it was then that the UV/Y came into existence, essentially carrying the torch passed on by the "old CRB Index." This gives us an equal-weighted commodity index that is diversified across all major commodities, and which is accessible through an ETF that is listed on the New York Stock Exchange (NYSE). On April 17, 2013, the UV/Y index ceased to exist. As a result of this index deletion, DWA picked up construction of the index internally because we believe strongly in having both equally weighted and cap weighted indices.

The Goldman Sachs Spot Return Commodity Index (GN/Y) has become a favorite among institutions as a premier global commodity benchmark for measuring investment performance in the commodity markets. The GN/Y is currently composed of 24 commodities that meet certain liquidity requirements and are weighted by the world production quantities. The index is rebalanced annually. So for use as an economic indicator, the appropriate weight to assign each commodity is in proportion to the amount of that commodity flowing through the economy (i.e., the actual production or consumption of that commodity). The GN/Y is not only a valuable commodity index to use for economic analysis, but it is also tradable via futures contracts on the Chicago Mercantile Exchange (CME), as well as through open-end mutual funds, and ETFs and exchange-traded notes (ETNs) on the NYSE.

The Dow Jones–UBS Commodity Index, formerly the Dow Jones–AIG Commodity Index (DJAIG), was established in July 1998. Originally, it was available only as an over-the-counter (OTC) product, but then the Chicago Board of Trade (CBOT) introduced futures contracts on the index, making it easier to invest in this commodity index as an asset class. The DJAIG is composed of futures contracts on 20 different exchange-traded physical commodities and uses a combination of liquidity and production data to determine its component weightings. Like the GN/Y, the DJAIG is rebalanced annually. Unlike the GN/Y, which has close to 73 percent of its weight in energy, no related group of commodities may constitute more than 33 percent of the index. In addition, no single commodity may constitute less than 2 percent of the index. The DJAIG is also available in an ETN that trades on the NYSE.

It is important to stay abreast of the specific weightings within commodity indexes, as their price action can be greatly affected by one group in particular, such as Energy in the case of the GN/Y (see Figure 11.6). Not only can these indexes provide knowledge on a macroeconomic basis, but as we've mentioned, both the Goldman Sachs Commodity Index and

	Goldman Sachs Commodity Index GSCI	Dow Jones UBS Commodity Index	RJ/CRB Index	Contoniuous Commodity Index
Crude Oil	30.25%	8.21%	23.00%	5.88%
Brent Crude Oil	17.35%	4.89%		
Uleaded Gas	4.74%	3.37%	5.00%	
Heating Oil	4.75%	3.34%	5.00%	5.88%
Gasoil	7.49%			
Natural Gas	2.94%	10.79%	6.00%	5.88%
Aluminum	2.53%	5.60%	6.00%	
Copper	3.74%	7.23%	6.00%	5.88%
Lead	0.47%			
Nickel	0.79%	2.37%	1.00%	
Zinc	0.61%	3.29%		
Gold	2.68%	10.05%	6.00%	5.88%
Silver	0.54%	3.12%	1.00%	5.88%
Platinum				5.88%
Wheat	3.22%	6.70%	1.00%	5.88%
Red Wheat	0.99%			
Soybean Oil		3.25%		
Orange Juice			1.00%	5.88%
Corn	4.64%	7.33%	6.00%	5.88%
Soybeans	2.55%	8.87%	6.00%	5.88%
Cotton	1.79%	1.38%	5.00%	5.88%
Sugar	2.28%	3.08%	5.00%	5.88%
Coffee	1.02%	1.88%	5.00%	5.88%
Cocoa	0.30%		5.00%	5.88%
Live Cattle	2.42%	3.52%	6.00%	5.88%
Feeder Cattle	0.41%			
Live Hogs				
Lean Hogs	1.49%	1.74%	1.00%	5.88%
Energy	**67.52%**	**30.60%**	**39.00%**	**17.64%**
Industrial Metals	**8.14%**	**18.49%**	**13.00%**	**23.52%**
Precious Metals	**3.22%**	**13.17%**	**7.00%**	**17.64%**
Agriculture	**16.79%**	**32.49%**	**34.00%**	**47.04%**
Livestock	**4.32%**	**5.26%**	**7.00%**	**11.76%**

Data as of September 2012

FIGURE 11.6 Commodity Index Weightings

Dow Jones AIG Index can be traded as an asset class via their individual futures contracts, open-end mutual funds, or exchange-traded products. The latter providing access to this asset class much in the same manner as S&P Depository Receipts (SPY) provide access to the S&P 500 and the large-cap equity asset class. The image highlights the different indexes' allocations to individual commodities.

Invest in Commodities as an Asset Class

Diversification

There are many sound reasons for adding commodities to your investment process, not the least of which being a tendency toward noncorrelation between stocks and commodities over time. Thus, the commodity markets

give the investor a means to diversify assets, without sacrificing performance in doing so. The more common approach toward diversification within "risk" assets is to allocate funds toward large-cap stocks, small-cap stocks, and international stocks, to achieve an overall portfolio allocation. However, many "diversified" investors have found out the hard way that simply spreading money around different regions or style boxes is not true diversification. Instead, they've found a certain fallacy of composition in assuming that foreign stocks are not correlated to U.S. stocks, or that small-cap stocks are in no way correlated to large cap stocks. A "diversified" portfolio of some of the largest, most widely held, mutual funds in existence can still fall prey to a deceivingly high correlation with the S&P 500 (see Figure 11.7).

A tremendous benefit that commodities can provide to an account is better diversification; which is to say diversification by means of a historically noncorrelated asset. Diversification is something to consider within your "commodity" asset class as well, where it can reduce "avoidable risk." One way to provide diversification in your commodity account is to trade different markets. It is important to keep in mind that diversification increases with more markets, but it does so at a decreasing rate as more and more markets are added. The added diversification provided by tangible goods, such as agriculture or petroleum, is rooted in the premise that these goods are impacted by different factors than stocks or bonds. That doesn't mean that when stocks are going down commodities will always go up. We needn't look any further than 2008, where everything became correlated, for a rare example of stocks and commodities falling in the same year. However, it does mean that if they both go down it is likely for very different reasons, which is as far as

Correlation to the S&P 500 for 2012
3-Year Range

	Value		Blend		Growth	
Large	S&P 500 Value Index	0.974	S&P 500 Index	1.000	S&P 500 Growth Index	0.974
Mid	S&P Mid Cap 400 Value Index	0.939	S&P Mid Cap 400 Index	0.949	S&P Mid Cap 400 Growth Index	0.934
Small	S&P Small Cap 600 Value Index	0.889	S&P Small Cap 600 Index	0.900	S&P Small Cap 600 Growth Index	0.906

International Equities	
MSCI EAFE Index	0.853
MSCI Emerging Markets Index	0.858

Fixed Income	
Vanguard Total Bond Market ETF	-0.209
Barclays Aggregate Bond Index	-0.111

FIGURE 11.7 Portfolio Correlation Example

diversification is meant to go. As evidence, it is worth pointing out that there have been only three years since the Goldman Sachs Commodity Index was established (1970) that both stocks and commodities have been down in the same year: 1981, 2001, and 2008. The most recent instance of this was, of course, 2008. As the margin clerks took control of virtually every risk market, following the mandate to "sell now and ask questions later," they pitched everything to raise cash for banks amidst the global financial crisis. Still, it is infrequent to see stocks and commodities down in the same year.

Inflation

The second major reason to consider commodities as part of a broader portfolio is as a hedge against inflation. Typically, when inflation rises, so too does the cost of producing goods and borrowing funds. Each of these tends to have a negative impact on stock and bond investments over time. Commodities, however, can benefit in this environment, as rising prices for raw materials (which are commodities, after all) benefit the investor who owns a fund invested in these same raw materials.

In such an environment, when inflation may or may not be led by rising energy prices, an investor may seek a commodity investment less correlated with crude oil at times, and more correlated to a broader investment in raw materials. Currently, the most evenly diversified option among commodity-based indexes that are traded via open or closed-end funds is the Greenhaven Continuous Commodity Fund (GCC), which is an ETF designed to track the Thomson Reuters Equal Weight Continuous Commodity Total Return Index (CCITR).

Opportunities for Capital Appreciation—The Exchange-Traded Funds

In recent years, we have seen a growing number of market vehicles begin trading, which allow for access to the commodities market on an exchange-traded basis. Both broad-based commodity index products have been introduced, as have more focused products that allow participation within very narrow commodity markets. In either case, these exchange-traded products allow investors to gain access to these respective markets without the leverage associated with commodity-based futures contracts. For instance, the iShares Gold Trust (IAU) is an exchange-traded fund that

is indexed to the price of gold. One share of IAU represents ownership of one tenth of an ounce of gold bullion that is actually held in a vault. If gold is valued at $1,600 per ounce, one share of IAU will trade at roughly $160 per share. For an investor to gain the exposure of 100 ounces of gold they must buy $1,600,000 of IAU. This is contrary to an investment in gold futures contracts, where one gold contract represents 100 ounces of gold but requires only an initial margin requirement $9,113 to be met upon purchase.

That, in essence, is how future contracts create such leverage and how I managed to get myself well beyond my "sleeping point" with my aforementioned cattle trade. The math behind the leverage goes something like this. A 10 percent move in the price of spot gold would create an expectation for a 10 percent change in value for IAU shares. That is pretty straight forward; IAU invests in gold bullion rather than gold futures, bypassing the leveraged experience in the process. And so that 10 percent move in the price of gold itself equates to a $160,000 fluctuation on that hypothetical investment of $1,600,000 in IAU. Certainly, that is painful if gold is moving against you, rather than for you, but you are feeling no more pain than is the person with gold coins in a safety deposit box or buried in a coffee can in the backyard. Let's consider the trader in the futures market, who has instead put up just $9,113 (initial margin requirement on one contact) to become long a single gold futures contract (or $160,000 of exposure). The same change in the price of spot gold, 10 percent, has created a $16,000 unrealized credit or debit in the futures account. The commodity trader is either sitting on a gain of 175% relative to the initial investment, or is staring at a net debit of ($6,887), in addition to the initial margin, and is fielding a call from the margin clerk on the topic of raising more cash in order to maintain the long exposure in the gold contract. This is the double-edged nature of the futures market and the reality of how overleveraging can force your hand. You may believe you are on the right side of the trade, but if the market determines otherwise, even initially, overleveraging will limit your options quickly (see Figure 11.8).

Many exchange-traded commodity vehicles are created to allow for dollar-for-dollar exposure to a commodity index or individual commodity market, which is to say they eschew the leverage of direct investment in a futures contract. The analysis for buying or selling these funds is little different than that described earlier for entering a futures contract; it is primarily the leverage that is different. The existing commodity-based

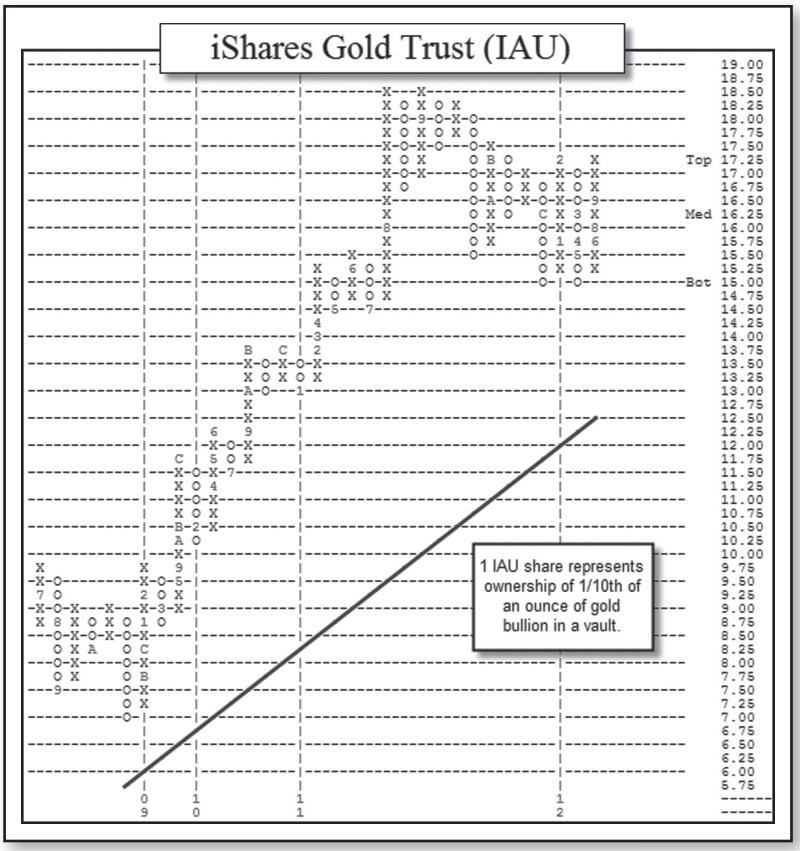

FIGURE 11.8 iShares Gold Trust (IAU)

open-end (mutual funds) and exchange-traded products available as of this writing are found in Figure 11.9, a list that has grown substantially along with the growing interest in markets in recent years. There are now many long-oriented products, inverse (short) products, and levered products that provide 2:1 or 3:1 leverage on a respective side of the market. The products will surely continue to evolve, but the process of managing positions successfully within them is no different than when I was dragged into the commodity markets after the stock market crash of 1987. Follow the prevailing trends, use sound risk management practices and avoid overleverage. These are recipes for success in trading generally, and trading commodity markets particularly.

Broad Commodity Index Funds	
Elements Rogers Int'l Commodity Total Return ETN	RJI
Elements S&P Commodity Trends Indicator Total Return ETN	LSC
E-TRACS UBS Bloomberg CMCI Index ETN	UCI
E-TRACS UBS DJ-UBS Commodity ETN	DJCI
E-TRACS UBS DJ-UBS Commodity Index 2-4-6 Blended Futures ETN	BLND
Greenhaven Continuous Commodity	GCC
GS Connect S&P GSCI Enhanced Commodity ETN	GSC
iPath DJ AIG Commodity ETN	DJP
iPath Pure Beta Broad Commodity ETN	BCM
iPath Pure Beta S&P GSCI Weighted ETN	SBV
iPath S&P GSCI Commodity ETN	GSP
iShares GSCI Commodity	GSG
PowerShares DB Commodity Index	DBC
PowerShares DB Commodity Long ETN	DPU
STREAM S&P Dynamic Roll Global Commodities	BNPC
US Commodity Index	USCI

Agriculture Funds	
Elements Rogers Int'l Agriculture ETN	RJA
E-TRACS UBS Bloomberg CMCI Agriculture ETN	UAG
E-TRACS UBS Bloomberg CMCI Food ETN	FUD
E-TRACS UBS Bloomberg CMCI Livestock ETN	UBC
iPath DJ AIG Agriculture ETN	JJA
iPath DJ AIG Grains ETN	JJG
Elements MLCX Grains ETN	GRU
iPath DJ AIG Livestock ETN	COW
iPath Pure Beta Agriculture ETN	DIRT
iPath Pure Beta Grains ETN	WEET
iPath Pure Beta Livestock ETN	LSTK
PowerShares DB Agriculture	DBA
PowerShares DB Agriculture Long ETN	AGF
Teucrium Agriculture	TAGS
Teucrium Corn	CORN
Teucrium Wheat	WEAT
Teucrium Soybean	SOYB
US Agriculture	USAG

Industrial Metals Funds	
Elements Rogers Int'l Metals ETN	RJZ
E-TRACS UBS Bloomberg CMCI Industrial Metals ETN	UBM
iPath DJ AIG Aluminum ETN	JJU
iPath DJ AIG Copper ETN	JJC
iPath DJ AIG Industrial ETN	JJM
iPath DJ AIG Lead ETN	LD
iPath DJ AIG Nickel ETN	JJN
iPath DJ AIG Tin ETN	JJT
iPath Pure Beta Aluminum ETN	FOIL
iPath Pure Beta Copper ETN	CUPM
iPath Pure Beta Industrial Metals ETN	HEVY
iPath Pure Beta Lead ETN	LEDD
iPath Pure Beta Nickel ETN	NINI
PowerShares DB Base Metals	DBB
PowerShares DB Base Metals Long ETN	BDG
US Copper	CPER
US Metals	USMI

Energy Funds	
Elements MLCX Biofuels ETN	FUE
Elements Rogers Int'l Energy ETN	RJN
E-TRACS UBS Bloomberg CMCI Energy ETN	UBN
E-TRACS UBS Natural Gas Futures Contango ETN	GASZ
E-TRACS UBS Oil Futures Contango ETN	OILZ
iPath DJ AIG Energy ETN	JJE
iPath DJ AIG Natural Gas ETN	GAZ
iPath Global Carbon ETN	GRN
iPath Pure Beta Crude Oil ETN	OLEM
iPath Pure Beta Energy ETN	ONG
iPath Pure Beta Seasonal Natural Gas ETN	DCNG
iPath S&P GSCI Crude Oil ETN	OIL
PowerShares DB Crude Oil Long ETN	OLO
PowerShares DB Energy	DBE
PowerShares DB Oil	DBO
RBS Oil Trendpilot ETN	TWTI
Teucrium Crude Oil	CRUD
Teucrium Natural Gas	NAGS
US 12 Month Natural Gas	UNL
US 12 Month Oil	USL
US Brent Oil	BNO
US Diesel Heating Oil	UHN
US Gasoline	UGA
US Natural Gas	UNG
US Oil Fund	USO

Precious Metals Funds	
ETFS Asian Gold	AGOL
ETFS Gold	SGOL
ETFS Palladium	PALL
ETFS Physical Precious Metal Basket	GLTR
ETFS Platinum	PPLT
ETFS Silver	SIVR
ETFS White Metals	WITE
E-TRACS UBS Bloomberg CMCI Gold ETN	UBG
E-TRACS UBS Bloomberg CMCI Long Platinum ETN	PTM
E-TRACS UBS Bloomberg CMCI Short Platinum ETN	PTD
E-TRACS UBS Bloomberg CMCI Silver ETN	USV
iPath DJ AIG Platinum ETN	PGM
iPath DJ AIG Precious Metals ETN	JJP
iPath Pure Beta Precious Metals ETN	BLNG
iShares COMEX Gold	IAU
iShares Silver Trust	SLV
PowerShares DB Gold	DGL
PowerShares DB Precious Metals	DBP
PowerShares DB Silver	DBS
RBS Gold Trendpilot ETN	TBAR
SPDR Gold	GLD

Softs Funds	
iPath DJ AIG Cocoa ETN	NIB
iPath DJ AIG Coffee ETN	JO
iPath DJ AIG Cotton ETN	BAL
iPath DJ AIG Softs ETN	JJS
iPath DJ AIG Sugar ETN	SGG
iPath Pure Beta Cocoa ETN	CHOC
iPath Pure Beta Coffee ETN	CAFE
iPath Pure Beta Cotton ETN	CTNN
iPath Pure Beta Softs ETN	GRWN
iPath Pure Beta Sugar ETN	SGAR
Teucrium Sugar	CANE

Leverage/Inverse Funds	
PowerShares DB Agriculture Double Long ETN	DAG
PowerShares DB Agriculture Double Short ETN	AGA
PowerShares DB Agriculture Short ETN	ADZ
PowerShares DB Base Metals Double Long ETN	BDD
PowerShares DB Base Metals Double Short ETN	BOM
PowerShares DB Base Metals Short ETN	BOS
PowerShares DB Commodity Double Long ETN	DYY
PowerShares DB Commodity Double Short ETN	DEE
PowerShares DB Commodity Short ETN	DDP
PowerShares DB Crude Oil Double Short ETN	DTO
PowerShares DB Crude Oil Short ETN	SZO
PowerShares DB Gold Double Long ETN	DGP
PowerShares DB Gold Double Short ETN	DZZ
PowerShares DB Gold Short ETN	DGZ
ProShares Ultra DJ UBS Commodity	UCD
ProShares Ultra DJ UBS Crude Oil	UCO
ProShares Ultra DJ UBS Natural Gas	BOIL
ProShares Ultra Gold	UGL
ProShares Ultra Silver	AGQ
ProShares UltraShort DJ UBS Commodity	CMD
ProShares UltraShort DJ UBS Crude Oil	SCO
ProShares UltraShort DJ UBS Natural Gas	KOLD
ProShares UltraShort Gold	GLL
ProShares UltraShort Silver	ZSL
US Short Oil	DNO
VelocityShares 2x Inverse Copper ETN	SCPR
VelocityShares 2x Inverse Palladium ETN	IPAL
VelocityShares 2x Inverse Platimum ETN	IPLT
VelocityShares 2x Long Copper ETN	LCPR
VelocityShares 2x Long Palladium ETN	LPAL
VelocityShares 2x Long Platinum ETN	LPLT
VelocityShares 3x Inverse Brent Crude ETN	DOIL
VelocityShares 3x Inverse Crude ETN	DWTI
VelocityShares 3x Inverse Gold ETN	DGLD
VelocityShares 3x Inverse Natural Gas ETN	DGAZ
VelocityShares 3x Inverse Silver ETN	DSLV
VelocityShares 3x Long Brent Crude ETN	UOIL
VelocityShares 3x Long Crude ETN	UWTI
VelocityShares 3x Long Gold ETN	UGLD
VelocityShares 3x Long Natural Gas ETN	UGAZ
VelocityShares 3x Long Silver ETN	USLV

FIGURE 11.9 Commodity-Based Index Funds

Summary

By this point in our journey, we hope that at a minimum we agree on two things, the first of which being that simply having a set of rational tools at your disposal is quite helpful in deciphering the commodities markets, and second, that none of these tools need be hoes, pitchforks, or McCormick's famous reaper. Rather, while remaining attentive to a few key ingredients, which pertain to any commodity, we can begin to train ourselves to find consistent opportunity in the futures market. I would like to direct you to our commodity book title, *Commodity Strategies: High-Profit Techniques for Investors and Traders* (John Wiley Trading). It is the most comprehensive book on commodity investing using Point and Figure analysis available. For those of you who make commodity trading a major part of your investments, I highly recommend that you get this book.

CHAPTER 12

Trading Options Using Point and Figure

The key to understanding how option strategies are applied to stock portfolios is in gaining a basic grasp of the normal distribution concept we discussed in Chapter 7. This normal distribution shows up everywhere in nature. Sixty-eight percent of the time anything you evaluate—stock trades, men's heights, peoples' blood pressures worldwide, and so on—will fall one standard deviation above or below trend in a bell curve. What does this mean? Think of it this way. Each bell curve is constructed of six standard deviations or zones, three above center and three below center. Center is considered perfectly normal. In the stock market, stocks that decline in price fall down to the lower zones. Stocks that do well will rise to the upper zones. Sixty-eight percent of your trades will hang around the middle. In other words, most of your trades will be what I call "middling" or hanging around center. They go up a little, then fall back a little, then rise a little, and so on, but never become a clear winner you can sell for a profit, nor do they decline enough for you to consider the trade a bad bet and sell it. So the normal distribution of your trades might look like this (See Figure 12.1). This is the most simplistic way of explaining it because all you need is a visual concept of what I'm talking about.

You can see in Figure 12.1 that 68.2 percent of your trades are likely to fall in the dark blue portion of the curve. Truly winning trades will encompass about 15.7 percent as will the losing trades, with the remaining approximately

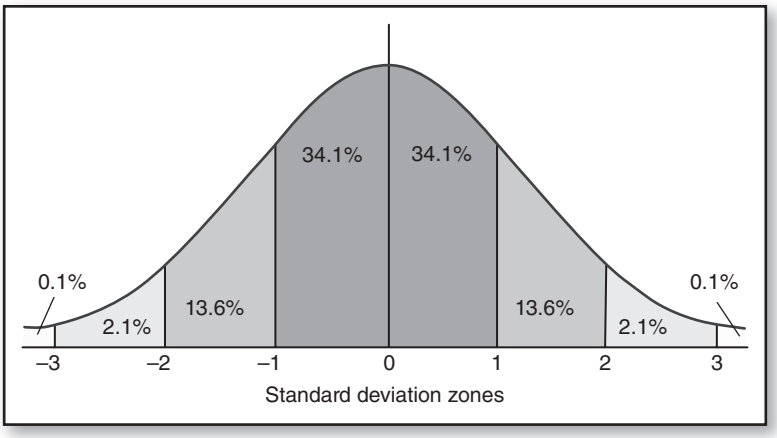

FIGURE 12.1 Trading Options: The Normal Distribution

0.2 percent going out the tails of the curve. A trade going outside the tails of the curve would be Apple Computer. In the past few years, it has had a run from $68 to $680. Now that's a trade. A $68,000 investment is now worth $680,000. As the stock rises, the expected normal distribution will also rise, making the distance from 100 percent oversold to 100 percent overbought a wide span. Utility stocks, which carry much lower volatility, will have normal distributions that carry small spreads between top and bottom.

Understanding the bell curve concept will help you understand how to use options to hedge risk in your portfolio.

Each stock has a normal distribution or bell curve. By applying a standard deviation calculation to any particular stock you generate a bell curve of its expected price movement. It gives the user tremendous perspective on the prevailing risk level of the stock by viewing where it lies on its own bell curve. Let's take a look at the chart of Apple Computer, September 2012 (Figure 12.2).

Notice on the righthand side of the chart you will see the words, Top, Med, Bot. Top means the stock is 100 percent overbought statistically. The probability is it will either pull back to a more normal price depicted by Med or Median price, or the curve will rise over time making this price normal. The normal distribution is dynamic not static. So by looking at APPL's chart I can see the stock is near the "Top" so it carries more risk buying it than if it were near the "Bot" level. "Bot" or 100 percent oversold is also three standard deviations below center or, in easier terms to think about, three "zones" below center. Conversely, "Top" is three standard deviations or zones above center. "Med" is right where the stock wants to be on a statistical basis. Knowing this helps you to understand which options strategy you might

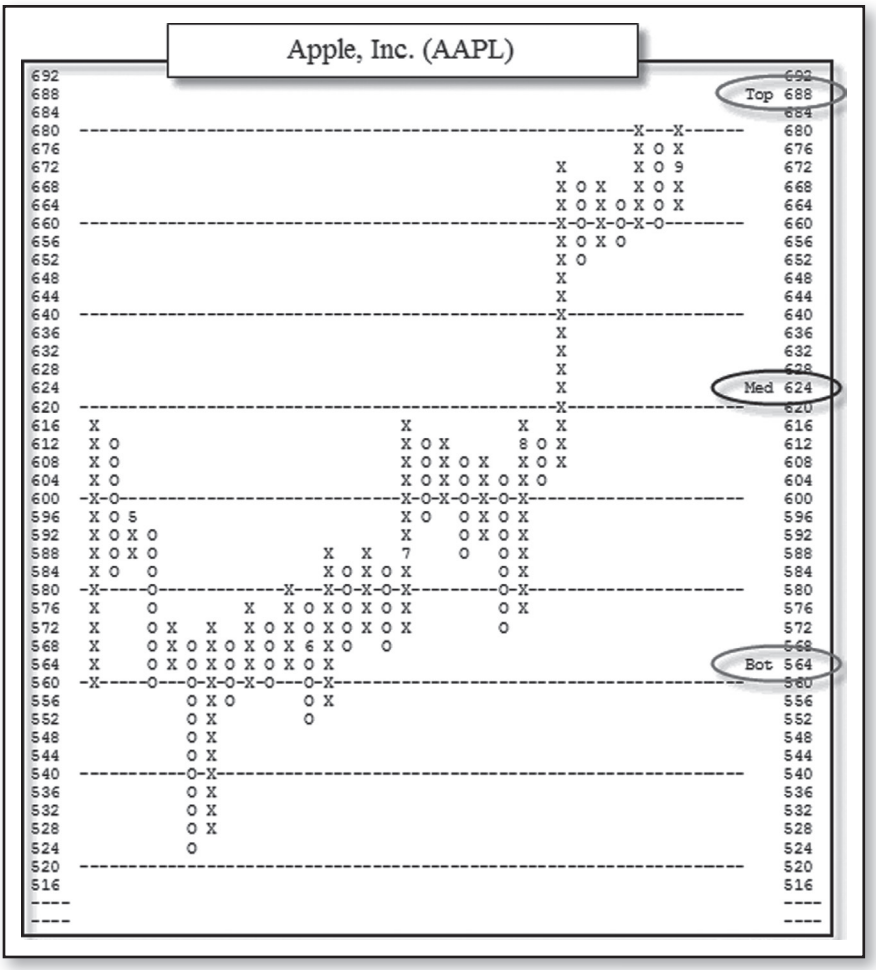

FIGURE 12.2 Trading Options: Apple's Normal Distribution

consider to help adjust the risk level of the stock. Options give you just that—options. Using options to help manage risk in a portfolio of stocks is one of the keys to long-term success in investing. Here's the problem. Most brokers do not use them, nor do their firms encourage it. This must change. Let's get on with the nuts and bolts of the options business. This chapter should be all you need to effectively use them.

The options business can be as complicated or simple as you want to make it. I developed and managed an options department for a broker-dealer for the better part of a decade. I've seen it all. I found out one thing for sure during that period—the more complicated the option strategy, the lower the probability of success. There are basically two strategies that make sense

for the individual investor: one is buying calls as stock substitutes; the other is using puts as an insurance product to protect portfolios against disastrous declines in the overall markets. Using options as a vehicle to speculate wildly in the market will surely result in losses in the long run. In the short run, anything is possible.

I have taught many classes on options to both stockbrokers and individual investors and have written numerous articles on the subject. The key to understanding options is in understanding the definitions of a put and call. All option strategies hinge on these definitions. No matter how difficult the strategy, if you break it down into its pieces and evaluate each piece separately, you will find that options are no more difficult than basic arithmetic.

Let's start with the definitions. Learn these well enough to write them down from memory. If you ever get confused with any particular option strategy, stop, write the definition down, and evaluate each piece of the strategy separately. This is exactly how I learned options. I took a legal pad home on weekends and practiced breaking strategies up into pieces. I would then evaluate the pieces at expiration when there was no time premium left in the option, and before I knew it, options became second nature. It can be just as easy for you. Just remember, keep it simple.

Call Definitions

Call Option (Buyer): This is a contract that gives the buyer the right to call (buy) 100 shares of the underlying stock covered by the contract, at a stipulated price (exercise price) and at a stipulated time in the future (expiration date), in return for paying a premium to the seller of that call. Numerous exercise prices are attached to each stock. They generally go in one-point intervals on lower-priced stock and five-point intervals on higher-priced stocks. You can see these intervals on Yahoo! Finance by clicking the options chain of any particular optionable stock.

Call Option (Seller): The seller of a call option contracts to sell 100 shares of the underlying stock covered by the contract, at a stipulated price (exercise price) and at a stipulated time in the future (expiration date). The seller receives the premium (cost of the option) from the buyer.

The Call Buyer

The buyer of a call has tremendous leverage because of the ability to control a large amount of stock for a very small amount of money. Leverage is

what draws investors to this arena. IBM is currently around the $195 level. A call option to buy IBM at $195 for the next five months costs $10.75 per share. Each contract represents 100 shares, so the total cost, not including commissions, is $1,750. One hundred shares of IBM at $195 would cost $19,500. To control that dollar amount of IBM for five months costs $1,750. You can see that the leverage can be quite high. Let's say you bought the call option we were just discussing. At expiration, IBM is at $225. What is your call worth? Here is where basic arithmetic comes in handy. Let's go back to the definition. The call buyer has the right to call stock away from the seller at a stipulated price. In this example, it is $195. At expiration, or any time before, you can exercise that right—you paid for it. If IBM at expiration is $225 and you have the right to buy the stock at $195, the value of the call is $30.

We arrive at that number by subtracting my cost to purchase IBM of $195 from my sale price of $225 per share, multiplied by 100 shares per contract or $3,000. Since you paid $1,075 for the call, subtract the cost of $1,075 from your gross profit and you get a net profit, not including commissions, of $1,925. That is about a 180 percent gain on the money you put up.

What if IBM instead went down to $185? If you held the contract until expiration, it would be worthless. Why? It would be worthless because you have the right to pay $195 and the stock is at $185. If you wanted to own the stock, you would be better off just buying it in the market. Leverage is a double-edged sword. Your loss in this case is 100 percent. Where most option traders go wrong is overleverage, buying more contracts than you would have an appetite for the underlying stock. I have done this many times and it has never worked out. It's a quick way to the poor house. Early on in my career as a stockbroker, I routinely allowed my clients to overleverage themselves. The standard number of option contracts most clients aspire to is 10. It's just a round number, and each point of profit equals $1,000 if you buy 10 contracts. Think of the example on IBM just presented. You could just as easily put up $10,750 for 10 contracts as you did $1,750 for 1 contract. With 10 contracts you are now controlling 1,000 shares of IBM at $195. This is now $195,000 worth of stock. The $10,750 is probably less than investors usually put up to buy stock. The difference here is that you are buying calls on 1,000 shares of stock. If your normal appetite for stock is, let's say, 300 shares, you have just overleveraged yourself by 700 shares. Such transactions lead to financial disaster. The net result could be that the stock goes down, the $10,750 is lost, and the customer says the option product is too speculative and is responsible for losing a good percentage of

investable capital. It wasn't the option product at all—it was the customer's desire to overleverage. Take my advice, if you are a 300-share buyer of stock; never buy more than three contracts. Manage your leverage.

The Call Writer (Seller)

The seller of that call is generally interested in capturing the premium income and is willing to give up the stock at the exercise price if the buyer of the call chooses to exercise the contract and take the stock. The individual should stick pretty much to the basics. Professionals use numerous exotic strategies that work for them simply because their transactional charges are almost nonexistent. One strategy the small investor often uses very effectively is the covered write. This is the strategy we discussed above that is the right strategy 68 percent of the time in an investor's career of investing. This strategy is simply an income-producing strategy in which the investor selling the call is willing to forgo potential upside appreciation in the stock in return for the premium income generated by selling the call. In 2012, most investors my age are looking for income. They need their pie out of the sky and on the table at this point in their lives. Let's take XYZ Corporation, for example. You own XYZ at $60 and feel the stock is likely to move sideways for a while. You might choose to sell a six-month call against your stock. Let's say you would receive $400 in cash for selling that $60 call on 100 shares (transaction fees are left out for simplicity). The $400 goes in your pocket now. You have received payment for contracting to give your stock up at $60 per share if the buyer of that contract so desires. If XYZ rises to $80, you will not get that capital gain. Your sales price will be $60. You knew that going in. If XYZ declines, the $400 received may partially or totally offset the loss. Your break-even price is $56 ($60 − $4 = $56). If at any time during the life of that contract you would like to negate it, you can simply instruct your broker to buy the same contract back. You will be at the mercy of the market and may pay more than you received, but the option to cancel is still open to you.

In our daily research, we regularly recommend covered writes and base our selection on several guidelines. The first rule is that the stock must be one that we believe is going up in price. In other words, the stock is trading above the bullish support line with positive relative strength. Next, we look at the return for selling the call. For us to recommend a covered write on a stock, the annualized called return should be 20 percent, the annualized static return should be 10 percent, and the downside protection should be 14 percent.

Put Definitions

Put Options (Buyer): The buyer of a put has the right to put (sell) stock to the writer of that put, at a stipulated price (exercise price), for a stipulated time in the future (expiration date), and for that right must pay a premium to the seller of that put.

Put Options (Seller): The seller (underwriter) of the put stands ready to buy stock at a stipulated price (exercise price) for a stipulated time in the future (expiration date), and receives the premium from the buyer.

Put Versatility

The put option is the most versatile option tool available. It is also the most misunderstood. There are primarily two strategies that make sense to the individual investor: buying puts as short sale substitutes and buying puts as insurance against severe declines in his portfolio. Let's look for a second at what a short sale is.

Selling Short

Many investors will not sell short. It is simply contrary to most investors' optimistic outlook on things, and I have to put myself into this camp. I can easily short commodities with no reservations but stocks are different for me. I don't know why. A completed trade in the stock market consists of a purchase and sale of the underlying stock. Most investors are familiar with buy first–sell later transactions. The short sale entails selling first and buying later. In the end, both ingredients are present for a completed trade, the purchase and sale. Short sellers simply make a bet the stock will decline rather than rise. They borrow the stock they want to sell short through a brokerage firm promising to replace the stock at a future date. Normally, the replacement comes through an open-market purchase of the stock he sold. It may be at a profit or a loss depending on whether the stock subsequently rose or declined following the sale. Short sellers are also liable for any dividends on the stock they borrow. Short sellers are important in the scheme of things because they provide liquidity to the marketplace, thus helping other market participants facilitate their trades.

Actually, stocks decline faster than they rise. There was a probability study done many years ago by Professor Davis at Purdue University. It only takes 3.9 months for bearish chart patterns to work out in a bear market

versus 7.2 months for bullish patterns to work out in a bull market. Bearish patterns work in bear markets 86.9 percent of the time, whereas bullish patterns work out in bull markets 83.7 percent of the time. This suggests you are better off selling short in a bear market than you are going long in a bull market. Why then do so few investors take advantage of selling short? Aside from the pessimistic view you must have on the market, there is theoretically unlimited risk in a short sale. If you buy a stock, it can only go to zero, and some do. There is no limit to how high a stock can go. The difference in buying a stock versus selling a stock short is that your risk is defined when you buy a stock and undefined when you sell short. Most investors prefer to stick to the known side of the equation. Short sales must also be done in a margin account. Many investors, like my mother, refused to go on margin no matter what. She still remembered how her father got wiped out as a result of margin (overleverage) in the 1929 crash. There is a tool, however, that can make the short sale more palatable to the individual investor.

Put Options as Short Sale Substitutes

How about using puts as short sale substitutes? Remember the definition of a put? It gives the buyer the right to sell stock at a certain price until the expiration date of the contract. Let's say you bought a put on XYZ with an exercise price of $60 and an expiration date six months hence. For that right, you pay a premium of $4 × 100 shares or $400. (We'll use the same numbers as we did in the call example to keep things simple.) At the end of that period, XYZ is at $45. If you have the right to sell XYZ at $60 and it is currently selling in the market at $45, the put option must have some value. That value is the difference between what you can get by selling the stock versus what you must pay to buy the stock. What you could do is buy 100 shares of XYZ at the current market price of $45 and then exercise your put option to sell at $60. Your profit is $15 per share. Although you could go through those paces, very few investors do. If XYZ is at $45 at expiration, your put with an exercise price of $60 will be worth $15. All you have to do is instruct your broker to sell your option.

I have purposely left out examples prior to expiration because other variables such as time to expiration, volatility, and the prevailing risk-free interest rate come into play to determine the value of the option above its basic intrinsic value. Since this book is not designed to focus on options, I will leave the nuances of options for you to explore in other books devoted entirely to the subject.

What if XYZ did not go down but instead went up 15 points? It's simple—your put option would expire worthless if you held it to expiration. Why? Go back to the definition. The buyer of a put option has the right to sell stock. In this case, it is at a price of $60. If XYZ rose to $75, you would have to buy stock at $75 and then exercise your right to sell at $60. No one would do that, so the contract would expire worthless. Your loss as the put buyer would be $400—that's it—no matter how high XYZ went.

This is the main difference in risk versus the outright short sale. In a bad situation, your risk is defined by the amount you paid for the option. In a short sale, the pain just gets worse as the stock goes against you. If you want to talk about sleep deprivation, short sales will do it. Remember, any time during the life of the contract you can sell that put at whatever the market price is at that time. You do not have to wait until expiration to sell the contract. You can sell it 15 minutes after you buy it if you choose. In this example, the put provided a way to participate in an expected down-move in XYZ with a defined risk of the premium paid. In this way, put buying can be much more palatable to the individual investor than selling short.

Selling Puts—the Underwriter

The put sellers are a special breed of investor who in many cases really don't understand what they are getting into. Describing the fast-paced 1980s will add flavor to my explanation of this strategy. During that decade, the option business ran rampant. Options were still relatively new, at least as listed products. The market just continued to go up, so the easier it got, the more speculative investors became. Selling put options slowly but surely began to expand in popularity until it reached its height in 1987. Whenever a speculative bubble is produced, a pin is not far away. The pin became evident in October 1987. The decade of the 1980s was an amazing period for the option product. It was like Dodge City with the sheriff on vacation.

I was once a featured speaker at an American Stock Exchange Options Colloquium. The AMEX holds this forum each year to give the so-called options experts in the world the opportunity to share their profound research with other practitioners in the investment business. I was so proud to be accepted as a speaker at such a high-powered conference and gave a presentation on the merits of naked straddle writing on index options. I discussed how conservative the strategy was and how the then margin rules helped

augment the returns when Treasury bills were put up as collateral for the strategy. I break out in a cold sweat when I think of this speech, which I gave before the 1987 crash. Prior to 1987, virtually no one expected a decline of that magnitude—not in one day. Anyone following my grand plan found out in short order how painful selling put options on indexes could be. In fact, anyone selling any puts found it distasteful at best. We live and learn, but what a hard lesson this was.

What is the investor's motive for entering into this type of strategy? The put seller is simply the underwriter of the insurance policy the previous investor bought for protection. Concerning your car, an insurance seller might be Aetna Life and Casualty, Allstate, USAA, or any of a hundred other insurance companies. Sellers of a put or insurance are simply stating they are perfectly willing and capable of underwriting the risk outlined in the contract. In the case of the car, the insurance company is willing to buy your car from you if you have an accident. In the case of the put, the insurance underwriter is willing to buy your stock from you at the stipulated price if your stock has an accident. The put writer or underwriter is seeking to capture the premium on the contract just as an auto insurer does. It is the premium income from the sale of the contract that interests the underwriter, not capital gain. The success of an insurance company hinges on diversification, and lots of it. The insurance company knows it will have to pay off a certain amount of policies, but not the majority. Put writers typically can't get the diversification they need to act as an insurance company. Typically, put sellers speculate that the stocks they sell puts on will not have an accident. In 1987, all stocks had an accident on October 19 and the same thing happened throughout 2008. If all the automobiles in the United States were to have an accident on the same day, the insurance industry would be wiped out. Put sellers in October 1987 were wiped out. But in a meltdown market like 2008 where it was spread out over the whole year, ups, downs, ups, downs and ultimately down, the insurance companies could have coped with it. Not 1987, all in one day. Almost all put writers at that time were undercapitalized and totally unprepared for the consequences of contracts they had promised to fulfill. Wall Street was in total disarray, and it was rumored that some brokerage houses would go under. I know of numerous cases where people lost their whole life savings and more. This created a rash of lawsuits on Wall Street from brokers who demanded payment for the losses generated by the crash and from customers who sued the broker for allowing them to engage in an investment that was unsuitable for their investment objectives and temperament.

Overnight, the option product went from being the darling of Wall Street to being a product that was to be avoided at all costs. The repercussions are still with us. Some brokerage firms will not allow new brokers to engage in option trading until they have been in the business for three years and in 2012, firms still eschew options in any capacity. To me, this only speaks of a fantastic opportunity for a broker that wants to get the business no one else wants.

Most investors blame the trouble on the option product itself but the real problem was overleverage, not options. I guess you could call it basic greed. Recently, we have had another bubble burst. It had to do with overleverage again. This time, it was primarily confined to the housing markets, subprime bonds, and bond derivatives (another name for option products). Major losses were taken by so-called conservative bond funds, state municipalities, and individual investors. The losses were mind boggling. Again, the culprit was overleverage, and lack of proper regulatory oversight on the government's part, not the option product. The put option AIG Insurance Company was selling was called the credit default swap, aka put option. Here is where the problem became a catastrophe. If you went into a brokerage office and wanted to open an account to sell put options uncovered or "naked," pledging to buy stock if someone on the other side of the contract exercised it, you would be required to put up collateral to demonstrate that you could buy the stock if you were required to. AIG was not required by Congress to have any collateral backing the uncovered puts (credit default swaps) they were selling. Why would you need collateral? Real estate never goes down—"they don't make any more of it." Well, we can now dispel this myth. Real estate can go down and big time. I recently saw a cartoon of a homeless man sitting on a sidewalk with a cup begging for change. He had a sign beside him saying "No Derivatives Please." Some tremendous books have been written on options if you really want to get into it, but for the purposes of this chapter, I want to present some basic ideas on how you can successfully trade options.

Before the crash of 1987, it seemed everyone wanted to get into the game regardless of expertise. I can remember an elderly couple coming into our brokerage firm and telling their broker they wanted to increase their retirement income by selling uncovered put options. They would collateralize the puts with the fully paid Treasury bills they had in their brokerage account. You see, they had heard of this strategy at their bridge club. Apparently, other members of the club had been employing the strategy very successfully. It would work well as long as the market and the stocks they sold puts

on kept going up. A major decline in the market and stocks in general would spell financial disaster for most of them. Remember the definition of buying and selling puts.

Puts as Insurance Policies

To explain puts from a different angle, that of buying insurance, let me ask you a question. Do you own a put—yes or no? Okay, let me ask you one more question. Do you own a car? If the answer to the second question is yes, you own a car, then the answer to the first question is also yes, you own a put. If you own a car, you also own some insurance on the car. Puts are simply insurance policies. A put option gives the buyer of the put the right to sell stock at a certain price, for a certain time period by paying a premium (cost of the put) for this right. Your insurance policy on your car effectively says you can do the same thing. Let's say you have an accident that leaves your car a total wreck. Your insurance policy will pay you for that wrecked car. Your policy states in the event of an accident, the insurance company will pay you a stipulated amount of money covering the extent of the damages. The insurance policy stays in effect for a certain period of time, let's say six months, at the end of which time you must renew or cancel the policy. For the right to own that insurance policy, you pay a premium to the underwriter or seller of that policy, the insurance company. When I was a teenager, I had an accident in my father's car that bent the frame. The car couldn't be repaired. The insurance company paid us book value for the car minus the deductible. I actually think we made out on that deal. My dad didn't.

The put option is no different. Since put buyers have the right to sell stock (underlying stock) at a certain price (exercise price) for a certain period (expiration date) they are entering into a contract very similar to the one you have on your car. Option contracts always represent 100 shares of stock. Let's say you buy XYZ at $60 per share. Let's also say you want to protect against a major decline in the market that will undoubtedly include XYZ. You might consider buying a six-month put option with an exercise price of $60. The put might cost you $3 per share of stock or $300 (in the previous example we used $400). So we moved a little closer to expiration and thus the reduced price of the option. Option prices change daily as time to expiration as well as other factors change. If XYZ declined to $50 over the next six months, you could simply notify your broker you would like to exercise your put contract that stipulates you can sell XYZ at $60 per share.

You might also decide to hold the stock and simply sell the option for the gain. In our example, XYZ had an accident and declined to $50 per share. By exercising your put contract, you would be able to sell 100 shares of Philip Morris at $60. With the stock now at $50, you protected yourself by $1,000. Now what did it cost you to get that protection? The cost was $300 so your net protection was $700. If XYZ didn't have an accident and remained at $60 or higher, the put insurance policy would simply lapse. When we buy insurance policies, we always hope we don't have to use them. So to recap, the put buyer can also be interested in insuring his portfolio rather than making a bet the stock will decline.

The key to successful option trading is successful stock trading. You must be right on the stock before you can be right on the option. Before you select an option to buy, you must first go through the steps I have outlined for stock selection in the previous chapters of this book. You cannot even consider an option until you have done your homework on the underlying stock.

I have tried to avoid confusing terminology thus far but the following definitions will help you to understand options more thoroughly:

Delta: The amount an option will move in relation to a one-dollar move in the underlying stock.

Exercise price: The stated price to buy the underlying stock in a contract, generally fixed at 1- to 5-point intervals depending on the price of the stock.

Expiration date: The date on which the option contract expires. The owner of an option can sell the contract at any time before expiration at prevailing market prices. The seller of an option may repurchase the option he sold at prevailing market prices.

Option premium: The value of the option determined by market forces, including underlying stock's volatility, risk-free interest rate, time to expiration, and underlying stock's dividend.

In-the-money: In the case of a call, an exercise price below current market prices of the underlying stock; in the case of a put, an exercise price above current market prices of the underlying stock. If it sounds confusing, go back to the definitions of puts and calls earlier in this chapter.

Out-of-the-money: In the case of a call, an exercise price above the current market price of the underlying stock; in the case of a put, an exercise price below the current market price of the underlying stock.

At-the-money: In the case of both put and call, an exercise price and underlying stock price that are the same.

Intrinsic value: With reference to the premium of an option, the amount the option is in-the-money. If IBM was at 65 and an October 60 call was trading at $6, we would say that $5 of that $6 represents intrinsic value (amount in-the-money) and $1 of that $6 represents time to expiration. If the stock just sat there until expiration, the call option would eventually be worth the exact amount it was in-the-money—in this case, $5.

Time premium: The value of an option above its intrinsic value. If there is no intrinsic value the total cost of the option represents time to expiration.

The key to successful option trading is successful stock trading. If you are wrong on the stock, you will be wrong on the option. All we want the option to do is replicate the stock as much as possible. Once you have selected the underlying stock, then and only then can you consider the option. This is where the term *delta* comes into play. The deeper the put or call is in-the-money, the higher the correlation to a point-for-point move with the underlying stock.

Rule of Thumb for Deltas

A general guideline for deltas is as follows: an option that is 5 points in-the-money will have an option delta approximately 75 percent. In other words, you can expect about a ¾-point move in the option for each 1-point move in the stock. An option that is at-the-money will approximate a delta of 50 percent, and an option that is 5 points out-of-the-money will have a delta approximating 25 percent. Computers can fine-tune the delta down to one tenth of a percent, but who needs to know exactly what the delta is when market forces keep that figure in constant flux? Just try to stay in the ballpark and you'll be fine.

When I was a broker, we usually bought options by price. What I mean is our selection typically had nothing to do with how the option would move in relation to the underlying stock. If a client had $1,000 available to buy options, we bought the exercise price that fit that client's pocketbook. Keep in mind that back in the 1970s and early 1980s we didn't know much about options. We flew by the seat of our pants. Let me give you an example. In the previously stated rule of thumb, I said that a strike price 5 points out-of-the-money would carry a delta (amount the option will move in relation to a 1-point move in the stock) of approximately 0.25. Let's say XYZ is at $60 per share and I choose to buy a three-month call with an exercise price of 65. The exercise price is 5 points above the current

price of the stock. We say it is 5 points out-of-the-money since "the money" is the current price of XYZ. The delta of this call option will be around 0.25. If XYZ moves up $1, my option will move up 0.25. At expiration, XYZ must be trading at $65 for this three-month call to be worth nothing. Think back to the definition. The buyer of a call has the right to call stock away from someone at a stipulated price. If the price is, in this case, $65 and the stock is currently at $65 there is no advantage to holding the call at expiration. Thus, its value is zero. This is a situation where the investor was dead right on the stock and dead wrong on the exercise price selection. Here are some of my rules of the road:

1. *Always buy in-the-money calls or puts because the delta is relatively high.* Remember you want the option to look as much like the stock as possible. Some strategists recommend you buy two at-the-money calls instead of one in-the-money call to replicate the move in the stock. Think about that statement for a moment. We said in the rule of thumb that an at-the-money call had an approximate delta of 0.50. If you bought two options with a delta of 0.50, you would have a delta of 0.50 + 0.50 = 1. This would give you a move in the combined options of 1. As the stock rose, moving further in the money, the deltas would increase thus giving you a greater than 1 move in the calls versus the stock. The only problem with this is that if the stock sits still during the life of the contract (which can often happen), the total premium paid will be lost. Since a deep in-the-money call is almost all intrinsic value, the time premium will be minimal. Thus if a stock stays neutral during the life of the contract, the majority of the option's price will remain intact. In my estimation, this aspect of an in-the-money call is more important than gaining any added delta from the purchase of two at-the-money calls.
2. *Never overleverage.* Only buy as many contracts as you would otherwise buy round lots of the underlying stock. Keep the remaining money you would have invested in the stock in the money market fund. Overleverage is a very common mistake made by options traders.
3. *Buy time.* Time is the silent killer of options, the Grim Reaper. Always go out longer than six weeks because time premium decays most rapidly beginning around six weeks to expiration. Since you are keying off a move in the underlying stock, be sure your option does not expire before the stock has a chance to gain some momentum. I like to think of this as buying an option as far out as my headlights can allow me to see. This is generally 90 days.

4. *Stop losses.* There are two ways to look at an option trade. The simplest is to look at the premium you pay for the put or call as your stop. Had you bought the underlying stock, you would have been willing to take a certain loss up to your stop point. You can consider that loss you would have taken in the stock as the premium you pay for the option. If the stock does not move in your favor, you simply hold until expiration. This gives you second and third chances to succeed. Lots can happen to a stock over a three-month period. Another possible loss-limiting strategy would be to sell the option at the point you would normally stop the loss in the stock. Since you are attempting to create a position in the option that is similar to the stock, treat the option as if it were the stock. This might save you 50 percent of the premium, but you also give up the chance to make it back later on. I have a tendency to play it both ways depending on the situation. The best thing to do for a stop is to not use a stop. I think it is best to hold all long options until expiration. This way you are never accused of being an options trader, who generally have limited success, and you totally take the emotion out of the position. Emotion is generally the factor that causes you to jump ship too soon or take a profit too soon.
5. *Keep it simple.* The more sophisticated, the lower the probability of success. Remember, you cannot consider an option before you have done all the work on the stock first.

In evaluating which option to buy, the market is your first consideration. Who has the ball? Buying calls in a bear-configured market will be difficult at best. However, bear-configured markets are conducive to put buying. Be sure you know who has the ball before you jump into the game. Check the short-term picture. It might be best to hold off the purchase of calls when the short-term indicators are bearish. Remember, time is the silent killer of options. Timing is everything here. The long-term trend might be bullish while the short-term trend is bearish. Have both the long and short term going in the same direction before you buy an option. Evaluate the sector Bullish Percent indexes before you select the stock. In the case of a call, the sector should be on one of the three buy signals and below the 50 percent level for optimum conditions. In the case of a put, the sector should be on one of the three sell signals and residing above the 50 percent level.

Once the sector is selected, find a stock within the sector that is fundamentally sound. Simply check to see if a Wall Street firm is recommending the purchase of this stock. The best place to start is with your broker. Most have numerous correspondent firms' research and can answer this question

in a moment. This goes a long way in ensuring the stock is fundamentally sound. Along with the fundamentals, it's nice to see some insider buying in the stock (like the president buying his own stock). This is not essential, but it's nice to have.

After you have selected the list of fundamentally sound stocks, check the Point and Figure chart patterns and select the best and strongest looking stock. Do these things and you increase your chances of having many more winning trades than losing trades.

PART III

Apply the Point and Figure Methodology to Your Investment Process

CHAPTER 13

Portfolio Construction and Management

Thus far in the book we have dissected the puzzle and examined each piece separately. Let's take a few moments and succinctly sum up the investment process. Think of this method of portfolio management as an operating system. This operating system is not unlike the operating systems one might download on a computer. A computer can do absolutely nothing until it has an operating system like Windows installed on its hard drive. Even the newest comer to the computer world knows this universal truth. Investing is no different. In fact, everything in life is a software program of sorts that is installed in your mind (hard drive), and you are in essence the sum total of the software programs running on your mind's hard drive. To be successful at investing, you need some way of evaluating the fire hose of information available on the subject of investing. You need some way of constricting that fire hose of information down to the trickle of a garden hose. This whole book is in essence that operating system we have found to be the most logical, easy to understand, sensible, and organized method of constructing and managing your portfolio. In the end, you must have accumulated more money than the market and the government can take away from you or you have failed in your quest for a sound retirement. Isn't that what we are all ultimately striving for? At the end of the road, we need more dollars in our account than when we started. We are more or less aggressive in this endeavor at various points in our life.

I want this chapter to be more of a cool-down period. So sit back and relax—you have already done the heavy lifting. Let's just briefly look at some of the steps that were covered in detail in the book to summarize the overall game or operating system if you will. Remember that this book comes with access to a Wiley web site with tools to help you solidify the concepts presented here. Here you will find all of the important concepts reinforced along with study questions. The lessons on the site were purposely constructed with a number of examples and investment situations for each topic. These examples and tests are designed to help you take the concepts you learned in the book and apply them to real-life situations that you are likely to experience when investing real money.

One of the best ways to learn how to use the Point and Figure method is to practice with real examples. My daughter Samantha is working for me now in a family office designed to manage our family assets. She is now learning all that this book has taught. She updates 100 charts by hand each day just to be sure she has a real feel for it. Although our system will do all the heavy lifting for you, it's good to be sure you know how to do everything by hand first. This makes a true craftsman. This is especially true for you professionals reading this. It will significantly help you make a presentation to a prospect on exactly what it is that defines you on Wall Street. Whenever we conduct our Point and Figure Institutes, we always teach a particular section, then do some practice examples relating to that section just covered. We culminate the seminar with several practice exercises, and in some instances a full case study, incorporating all the concepts taught at the Institute. Therefore, as you finish reading this book, which is like attending a Dorsey, Wright Point and Figure Institute, it is fitting to do some practice examples that bring all the information together. One of the things I recommend is that you get a sheet of paper and just write down the pros and the cons for the stock. Create a checklist with two columns, one positive and one negative, as well as a comments column. Then as you examine each of the attributes of the market, sector, and stock, put it in the positive or negative column. Your evaluation sheet would look something like the one shown in Figure 13.1.

Continue to do this exercise whenever you evaluate a position. It's like the notes you took in college. It helps you remember it by writing it down. Remember that on each chart there is a place to write down some notes. Once you feel comfortable with evaluating a stock, you are ready to visit our web site. The DWA Internet site makes this easier because with the click of a mouse, you will see an evaluation sheet automatically completed for you on your stock of choice. So sit back and relax. Let's talk concepts with a step-by-step discussion of constructing and managing a portfolio.

	Positive	Negative	Comment
Market			
Sector			
Sector RS			
Trend			
Relative Strength			
Peer Relative Strength			
Pattern			
Price Objective			
Stop loss point			

FIGURE 13.1 Incorporating the Concepts: The Stock Evaluation Chart

Steps for Constructing an Investment Portfolio

Step 1: Evaluate the Broad Market—Who's Got the Ball?

Evaluate the market to determine whether it is supporting higher prices or lower prices. Any type of business comes down to supply and demand—it's that simple. I don't care whether we are talking about the oil market, iPods, golf courses, lemonade stands, or the stock market. Simply said, when there are more buyers than sellers willing to sell, price will move higher. When there are more sellers than buyers willing to buy, price will move lower. When supply and demand are in equilibrium, price must remain the same. In the end, there is nothing else. The reason that the price of produce in the supermarket changes is the very same reason the prices on Wall Street change. The Point and Figure methodology is just a logical, sensible organized way of recording that supply-and-demand relationship. It simply arranges the information in a way that makes sense to the viewer. When demand is in control of the market, we want to focus on wealth accumulation strategies, and when supply is in control of the market, we want to focus on wealth preservation strategies.

The indicator that tells us whether supply or demand is in control of the market is the Bullish Percent. This is kept on a variety of markets but the two most important are the New York Stock Exchange (NYSE) and the over-the-counter (OTC) market. We consider these indicators our main coaches. The first thing I do each morning is check this indicator to see what team the coach is telling me to put on the field. I often log on at night to see how the Bullish Percents did before I go to bed.

From there, I'll pick my individual stock plays. Here are just some of the plays from our playbook, segregated by field position. Use this as a starting point for developing your own playbook. Figure 13.2 provides some ideas for plays to run when the market indicators are oversold, Figure 13.3 lays out some starting points for times when the market indicators are "middling" between 30 and 70 percent, and Figure 13.4 provides some starting points for times when the market indicators are overbought.

Market Indicators Oversold—Reward Greater, Lower Risk

Offense, in X's	Defense, in O's
Aggressive offense	Reduce defensive posture
Offensive sectors (BP in X's)	Build shopping list of ideas
More volatile sectors can be bought	Reduce exposure to defensive sectors
Buy ETFs to gain market exposure quickly	Liberal stops for strong RS positions
Buy stocks	Tighten up buy stops for short positions
Buy leaders and laggards on breakouts	Trim or take profits in shorts
Consider bottom fish plays	Take profits on long put positions
Liberal stop-loss points	Trim positions in inverse funds
Increase volatility	
Buy calls	
In-the-money covered writes	
Sell puts	

FIGURE 13.2 Running Plays when Market Indicators are Oversold

Market Indicators Middling between 30 and 70 Percent

Offense, in X's	Defense, in O's
Offensive posture	Defensive posture
Focus on strong RS sectors	Reduce equity exposure
Focus on sectors whose BP is in X's	Raise cash
Sell laggard stocks on rallies	Hold strong RS sectors
Focus on high tech attribute stocks	Sell weak RS sectors
Buy on pullbacks	Hold strong RS stocks
Use trend line stop-loss points	Sell laggards (weak RS)
Buy ETFs	Use trend line stop loss points
Covered writes	Inverse funds to hedge
Bull spreads	Protective puts to hedge
Covered combinations	Bear spreads

FIGURE 13.3 Running Plays when Market Indicators are between 30 and 70 percent.

Market Indicators Overbought—Risk Greater	
Offense, in X's	**Defense, in O's**
Reduce offensive posture	Aggressive defense
Increase exposure to defensive sectors	Decrease volatility
Trim sectors whose BP moves to O's	Raise cash levels
Trim offensive positions	Reduce exposure to offensive sectors
Sell any weak RS positions	Sell stocks on breakdowns (PnF sell)
Buy ETFs instead of specific stocks	Tighter stops
Add defensive positions	Buy protective puts to hedge
Tighter stop-loss points	Buy inverse funds to hedge
Buy calls as stock substitute	
Buy protective puts	

FIGURE 13.4 Running Plays when Market Indicators are Overbought

Step 2: Evaluate the Sectors

Seventy-five to 80 percent of the risk in any particular stock, exchange-traded fund (ETF), or mutual fund is the market and the sector. Because of this, we take a top-down approach when evaluating the market. Once we have determined the stance of the overall market, we move to individual sector evaluation. We are simply moving from the whole to the parts. Numerous internal and other academic studies have shown that over time a successful sector rotation strategy is paramount to portfolio success. Never deviating from the basic laws of supply and demand, we rely first on the Bullish Percent concept to tell us which sectors are on offense and which are on defense. Like the blobs in a lava lamp, you'll generally find that at any one given time, some are down at the bottom, some are the top and have been hot for a while, and others are huddling in the middle of the lamp. The beauty of the Bullish Percent concept is that once you understand it, it's easy to apply to different market segments. In some cases, most sectors will be huddling together in the middle and there are no great opportunities, and other times there will be an overabundance of opportunities. That's life on Wall Street. Simply stated, make the best of what you have.

To increase our odds even further with respect to sector rotation, we will overlay the Bullish Percent concept with a relative strength (RS) reading. This allows us to stack yet one more thing in our favor. We try to keep our focus on those sectors with the strong RS. This allows us to identify major themes and turning points in the market. Typically, these themes last for

several years. Where so many investors go wrong is they don't believe that the stock that has been strong can continue to stay strong. There's an old stock market adage that says the first stocks to double in a bull market usually double again. Or, as Sir Isaac Newton would say, "things in motion tend to stay in motion." The Point and Figure charts, Bullish Percents, and RS indicators will let us know when an investment theme is coming to an end. Having a sell discipline allows us to be comfortable owning those winners and letting them run. One of the fundamental truths to portfolio success is to cut your losses short and let your winners run.

Step 3: Creating an Inventory

There are many right answers in investing and all too often I see investors and brokers alike try to get their arms around too large of a universe of investment vehicles. My dad taught me "life's a cinch by the inch; life is hard by the yard." Take it inch by inch. In the DWA database we follow over 7,000 domestic stocks, 18,000 mutual funds, almost 1,500 ETFs, and over 75 exchanges across the world encompassing 20,000 international stocks. I don't throw out these figures to overwhelm you, but rather to point out the importance of determining your inventory. Do you like mutual funds? Pick a couple of fund families you believe in and concentrate on those. Maybe as an adviser you like working with money managers. Compile a list of managers whose management style you like and they will become your inventory. Maybe the ETF product is what appeals to you. There is a terrific universe of those available. Do you prefer to work with individual stocks? If so, start with a fundamental inventory. I feel more comfortable working with a list of fundamentally sound stocks. I know full well a fundamentally sound stock can act like a "cat" or a "dog" at any time because supply-and-demand imbalances are the only economic concept that drives price change, but I still feel more comfortable with a list of stocks that appear to have no fundamental cracks in the armor. The point is, you take that fire hose of products available to you and take it down to the trickle of a garden hose. It's easier to take a sip from a garden hose than a fire hose. Once you have your inventory established, you can use Point and Figure methodologies outlined in this book to enhance the portfolio strategies you are already using. Just keep everything in perspective. This is not a science. It's simply best to operate in a logical, organized manner. That's the key to success, not some hidden algorithm found on a dying miner in the Mohave Desert.

Step 4: Evaluate and Monitor the Point and Figure Technical Picture

Once your inventory is established and culled down to a reasonable number that gives you a cross-section of exposure to asset classes and sectors, evaluate the technicals of each stock (ETF, fund, manager, etc.) in the inventory to answer the question "what to buy and when to buy it?" and what you will do if all these plans go your way and what you will do if these plans do not go your way. It is essential you know this and you write it down for the future. It helps to go back and reevaluate exactly what you did and why you did it. Our computer systems can answer this question in a matter of two seconds. Twenty-five years ago, we did it all by hand. Today, we have even taught the computer to evaluate any investment vehicle from stocks to bonds to ETFs, and then explain in writing what it saw, what it recommends doing with the position and alternative ideas. I have been involved in the thought process on these technological advancements over the past 25 years and I'm continually amazed at where we are today and how we are able to provide such a great productivity system to you the investor. Once you understand it, our system almost runs itself. The beauty of this is that it gives you back your life. All the things we spent hours doing by hand are now done at the click of a computer mouse. It's hard to figure where technology goes from here. but I know we are only limited to our ability to communicate and these technologies continue to expand on a daily basis. Here's an example of our ability to communicate. We held a technical analysis and option strategy seminar in Kuala Lumpur, Malaysia, at a prominent hotel, while we taught from our offices here in Richmond, Virginia. That's technology. Guess what? That was years ago and leading edge at the time. Today, we can run circles around that technology and hold whole investor symposiums online as if you were right there. One day investors will be dealing mostly with something that resembles Apple's "Siri." Watch it happen.

Once a position is established, continually monitor the position for signs of impending change in the trend or RS of the stock. This is a pretty simple step but an important one. You must evaluate all your portfolios each day to become aware of something that might require action. The best way to do this is to put all your portfolios into our system separately, like Mr. and Mrs. Jones's, Retirement Account, and so on. Our system will watch the portfolio or group of stocks for you like a cyber assistant. You will then be able to simply click on the activity button for each portfolio. This activity screen will outline any changes that require your attention

with respect to the underlying portfolio. The process to do it is so simple. Just key the symbols of each stock, mutual fund, bond, and so on that each client owns in their portfolios into the DWA portfolio system or, as I prefer, simply place all the stocks all my clients own into one portfolio. The point I am getting at is this: the system will do the rest once it knows what to evaluate. Say you wanted to view each day anything that might require your attention in all your portfolios. In one second the system will separate all the stocks in all your portfolios and place them in groups like double-bottom sell signals, RS change to negative, RS change to positive, Peer RS turned positive, and so on. In one click of the computer mouse you just evaluated every portfolio under your management in a matter of a few minutes. This activity could be done each morning before the market open, but since our charting system is updated the night before, you can get a jump on things by taking a minute to review the portfolio after the kids are in bed.

Each of you will find your own way of managing this information. We have clients who spend hours each night with the data and others that can easily manage their accounts with some easy 1, 2, 3 steps. As you work with Point and Figure analysis, you will be amazed and delighted with your new-found ability to take control of your and your client's investment endeavors. At a minimum take a free trial of our Web-based global research platform and you will be amazed. We have something for the individual investor and the professional. It can be found at www.dorseywright.com.

Team Builder

I'd like to briefly introduce you to one more tool from the Dorsey, Wright web site, our Team Builder program. In my younger years I was a baseball player, and one day it occurred to me that the concept of team was a good way to approach portfolio construction and management. Why wouldn't I construct a portfolio like a baseball team? Each position on the field would be an asset class or a fund of sorts that covered a particular area of the portfolio. Say first base was U.S. equities. I might use our PowerShares DWA Technical Leaders ETF (PDP) or the Powershares DWA SmallCap Technical Leaders ETF (DWAS) for this base. Second base might be fixed-income exposure. Shortstop could be noncorrelated assets like commodities where something like the PowerShares DB Commodity Index Tracking Fund (DBC) could be used. Third base could be international exposure, and possibly you might

use our PowerShares DWA Technical Leaders Emerging Market ETF (PIE), and you could add our PowerShares DWA Technical Leaders Developed Markets ETF (PIZ). If you wanted overweight in the Far East you could add the Market Vectors Indonesia ETF (IDX) and the iShares MSCI Malaysia Index Fund (EWM). This leaves catcher as a possible cash component. Now for the outfield. Right field could be top sector exposure. For example, if Metals were a top sector, you might consider the iShares Dow Jones U.S. Basic Materials ETF (IYM). Centerfield might be oil-related sectors, and in this slot you could use the ETF, IYE, which is the iShares Dow Jones U.S. Energy Sector. The pitcher might fill the slot of technology. One likely player might be the Vanguard Information Technology ETF (VGT). In the dugout would be the rest of the ETFs or funds you wanted on your team. This vision made me feel very comfortable about creating and managing a team of funds. Ultimately, this turned into our Team Builder product we offer to our subscribers.

Through this Team Builder program an adviser or individual investor can design and review an asset allocation of ETFs or mutual funds, stocks, or anything that trades, for that matter. This program will allow an adviser to quickly narrow a massive 25,000-member asset universe down to a manageable team, in real time. It takes that fire hose of information down to the trickle of a garden hose. This can all be done in a matter of a few minutes. I think back 15 years, and we could not have even conceived of this because technology simply was not advanced enough to do the calculations on the run, like we need them done today.

Team Builder has a myriad of filters such as Asset Scores, Technical Attributes, Expense Ratios, and Net Assets, just to name a few. You simply put your criteria into the program, and in no time at all, the program displays the funds that meet that criteria. The program then displays these funds in an intuitive layout so the user can instantly evaluate the asset class each fund resides in.

This is the perfect way to manage a 401(k). Each 401(k) has a list of funds that are available for the participant. I worked with one company that gave its employees 26 pages of funds. They basically included everything, but the problem with that was that no one in the plan could begin to figure out what to do. I have also worked with plans that provided only a handful of funds to use. No matter the size, the key is being in the right place at the right time. Team Builder does this. If you're interested in learning more about the Team Builder's capabilities, you can click on the "Team Builder" link under the Mutual Fund tab inside of our web site, or feel free to give us a call.

Conclusion

When I was a broker back in the mid-1970s, I came to work unprepared every day. We simply didn't have a logical way of operating in our business back then. We took firm research and passed it on to our clients, hoping the stocks would rise so we could sell and replace them with other stocks that would then rise in price. It just did not work, period. It wasn't until 1978 that I came across the Point and Figure method of analysis purely by accident. When I learned it, I realized I had found the Holy Grail of investing. It was Economics 101, supply and demand. I knew then what I was put on this earth to do and that was to teach this method to my brothers and sisters in this business for the rest of my life. It is now 34 years later and I'm doing just that. This is not a book that is generally read once and then abandoned. I have read and reread this book even though I'm the author. Every time I read a chapter again, I am refreshed on something I have lost focus on. This book should be highlighted, underlined, dog-eared, scuffed up from use, and passed along to others. There is an old saying: "You can't keep it unless you give it away." You are one of my emissaries now, and you should pass this on to others. Without you they may never have the opportunity to truly take control of their finances and in the end their retirement. Possibly, with all of us passing the word, we can help others attain a secure and comfortable retirement. This book will take an individual and his or her family much further in this endeavor than any government program can. Having read this book from cover to cover, you are now in the DWA family. Welcome.

ABOUT THE WEB SITE

This appendix provides you with information on the contents of the web site that accompanies this book. To access the web site, go to www.wiley.com/go/dorsey4e and use the password: pnf13.

Learn the Point and Figure methodology in an interactive format with this educational web site. Designed to be used in conjunction with *Point and Figure Charting*, Fourth Edition, this web site will bring the concepts to life with additional examples and discussions as well as exercises and tests to refine your skills through a series of six lessons. Your progress and overall understanding will be evaluated and tracked with assistance in areas of weakness. By the completion of this interactive resource, you will have an important technical analysis tool to enhance your investments and portfolio performance. The web site also includes a glossary of terms and additional writings from Tom Dorsey and guests.

The web site will be updated with current research articles and relevant examples as they become available.

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For more information on Dorsey, Wright & Associates, visit www.dorseywright.com.

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