Investment Corner

by IMCZ Treasurer John Henry Smith

Diagnosing The Health of Your Investments With Charts

The Need for more Investment Knowledge

After the debacles of 2000 and 2008, savvy investors have realized that they need to take greater control over their own assets, recognizing that they need to learn much more about how they or their investment advisors manage their hard-earned money. However, many investors don't know where to turn, whom to trust, or what they must stop doing if they are to achieve dramatically superior investment performance.

You don't have to give your money to a new Bernie Madoff, who will take it but wouldn't tell you exactly what he will do with it. Instead, you can and should participate in an investment group, such as the IMCZ Investment Forum, and read a good book or two on investing, so that you can learn how to invest with real confidence. At the very least, you should endeavour to grasp sound principles and proven methods that will protect and build your investment portfolio over time. With the face of the stock markets changing, the time is now ripe to learn how to invest intelligently with critical knowledge.

In almost every field, there are tools available to help people evaluate current conditions correctly and receive accurate information. Doctors use EKGs, X-rays, MRIs and other 'pictures' to help with their diagnosis; the same is true in investing. A stock's price and volume history are recorded on charts to help investors determine whether the stock is intrinsically healthy or whether it is suffering from some disturbing malady.

"I'm disappointed; if anyone should have seen the red flags, it's you."

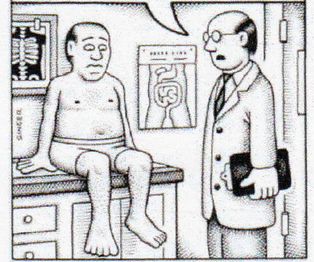
You wouldn't allow a doctor to perform stomach surgery on you if he hadn't used the necessary diagnostic tools beforehand. Yet many investors do exactly that when they buy and sell stocks without first consulting stock charts thus increasing their risks considerably. A lot of money can be lost if investors don't know how to recognize when a stock peaks and starts a significant correction or if they have been depending on someone else who also doesn't have the proper knowledge.

Charts record the factual price performance, which capture the results of daily supply and demand. Investors who train themselves to properly decode these price movements on charts have an enormous advantage over those who don't. Fortunes are made every year by those who take the time to learn to interpret charts properly. On the other hand, investors who don't make use of charts often lack the understanding of how the market really works and may miss the opportunities of key timing mechanisms. It's not enough to buy a stock simply because of its good fundamental characteristics, like strong earnings and sales. A stock's chart must always be checked to determine whether it is in a good buying position, or whether it is too far extended above a solid basing area and thus should be temporarily avoided.

Critical to investors are the chart patterns called "bases," which are simply areas of price correction and consolidation after an earlier price advance. Most of them (80% to 90%) are created and formed as a result of corrections in the general market. In interpreting these formations the skill is to diagnose whether the price and volume movements signal strength or weakness. Major advances occur in the wake of strong, recognizable price patterns whereas failures can always be traced to bases that are faulty or too obvious to the typical investor.

History Repeats Itself: Learn to Use Historical Precedents

Extensive analysis of the greatest winning stocks of the past show that they all have a number of successful price patterns and consolidation structures that consistently reoccur, proving that in the stock market, history repeats itself. This is because human nature doesn't change. Neither does the law of supply and demand. Price patterns of the great stocks of the past can clearly serve as models for your future selections. There are several price patterns you'll want to look for when you're analyzing a stock. Here is one of the most common of them!

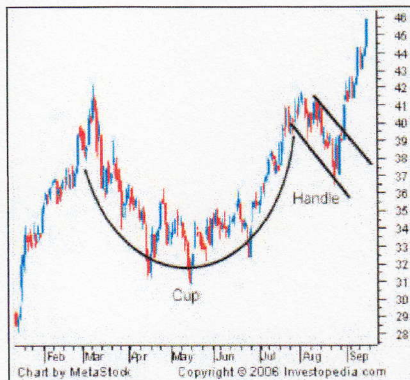


The "Cup with Handle" Pattern

One of the most important price patterns looks like a cup with a handle when the outline of the cup is viewed from the side. Cup patterns can last from seven up to 65 weeks, but most of them last for three to six months, The usual correction from the absolute peak (the top of the cup) to the low point (the bottom of the cup) of this price pattern varies from about 12% up to about 33%. A strong price pattern of any type should always have a clear and definite price uptrend prior to the beginning of its base pattern. You should look for an approximate increase of 30% in price in the prior uptrend, together with improving relative strength and a very substantial increase in the trading volume at some points in the uptrend prior to the formation of the downtrend.

In most, but not all, cases, the bottom part of the cup should be rounded and give the appearance of a "U" rather than a "V". This characteristic allows the stock time to proceed through a needed natural correction with two or three final little weak spells around the lows of the cup. The "U" area is important because it scares out the remaining weak holders and takes speculators' attention away from the stock. As the stock comes up to test the old highs, the stock will incur selling pressure by the people who bought at or near the old high. This selling pressure will make the stock price trade sideways with a tendency towards a downtrend for four days to four weeks... then it takes off!

It's normal for growth stocks to create cup patterns during intermediate declines in the general market and to correct 1 ½ to 2 ½ times the market averages. Your best choices are generally stocks with base patterns that deteriorate the least during such intermediate market declines. Whether you're in a bull or bear market, stock downturns that exceed 2 ½ times market averages are usually too wide and loose and must be regarded with suspicion. Dozens of former high-tech leaders, such as JDS formed wide, loose, and deep cup patterns in the second and third quarters of 2000. These were almost all faulty, failure-prone patterns signaling that the stocks should have been avoided when they attempted to break out to new highs.



A very small number of volatile leaders can plunge by as much as 40% or 50% in a bull market. Chart patterns that correct by more than this amount during bull markets have a higher rate of failure if they try to make new highs and resume their advance. The reason? A down-swing of over 50% from a peak to a low means that the stock must increase more than 100% from its low to get back to its old high. Historical research has shown that stocks that make new price highs after such huge moves tend to fail 5% to 15% beyond their breakout prices. Stocks that come straight off the bottom into new highs from cups without handles can be more risky because they had no pullbacks.

It pays handsomely to bear in mind the next time you look at a stock the Investment Forum's motto: Knowledge Guides, but add on: to Greater Fortune! ; on the other hand lack of diligence will lead your portfolio into uncharted territory.