

>: Keep Profits 'On The Move' With Moving Averages

Tuesday, May 19, 2009 / Chris Rowe

Last week, we discussed [the importance of understanding the market's trend](#), because the concept of trading *with* the trend is the main premise of technical analysis. Specifically, it's necessary when using a *shorter-term trend* to time your entry (or exit) points to determine *the next longer trend*.

For example: Short-term dips should be used as entry points if the intermediate trend is up and, when the intermediate trend is down, short-term pops should be viewed as short-selling opportunities.



Once you get clear picture of whether a stock is trading in an uptrend or a downtrend, the next thing you want to look at are its moving averages.

Use Moving Averages to Keep Profits 'Moving' Along

Moving averages are the lines on a chart that track the average price of a stock or index over a specific number of time periods (e.g., days, weeks, months, etc.) during a particular time frame. Remember, each bar in a chart represents a time period. (In a daily chart, for example, each time period represents one day, etc.)

Moving averages are generally used to smooth out the "noise" of the short-term volatility and, therefore, more easily identify major trends. They are also used to gauge the changes of momentum in an index or security.

The most basic kind of moving average, the "Simple Moving Average" (SMA), attributes equal weight to all time periods and averages out the sum. So, a 20-day moving average would typically average the closing price of each of the last 20 trading days.

There are several other types of moving averages, but the "Exponential Moving Average" (EMA) attributes more weight to the recent price activity. Some believe it makes more sense to use EMA over the SMA, as recent price is more relevant, but it's really a matter of personal preference. Personally, I prefer the EMA, although there is a place for both when doing technical analysis for your own portfolio.

- To identify the *short-term trend*, a 10-day (or 2-week) MA is typically used.
- To identify the *intermediate trend*, a 50-day (or 10-week) MA is typically used.
- To identify the *long-term trend*, a 200-day (or 40-week) MA is typically used.

Which time periods should be used to identify which trends?

Keep in mind that the direction of a trend can be defined either by the direction of moving averages or by highs and lows. For example, higher highs and higher lows typically constitute an uptrend, and *vice versa*. But for the purpose of this discussion, we'll focus on moving averages.

I have read, and I can also write, hundreds or probably a thousand pages on moving averages, but let's stick to the basics here.

Below is a one-year daily chart on Cisco Systems (and what a beautiful chart it was, when it was in this formation). The dark brown line shows the

long-term (200-day) moving average, the blue is the intermediate (50-day) moving average, and the light brown line that's hard to see, but has a green arrow pointing to it, is the short-term (10-day) moving average.



The smaller the trend (the smaller the moving average), the more volatile it will be.

During this particular 12-month period:

The long-term trend(200-day moving average) was up the entire time.

The intermediate trend

(50-day moving average) from the beginning of the chart was up. The upside momentum was increasing as evidenced by the faster, intermediate moving average diverging from the slower long-term one.

Then, in January, upside momentum decreased, signaling expected weakness in the stock. At the same time, the intermediate trend (50-day moving average) was slightly down to flat until June when it started to move upward again as the stock started to gain upside momentum again.

The short-term trend(10-day moving average) is by far the most volatile. It was up from August through October when it took a breather. The short-term trend was down from mid-October to early November. The shorter-term trend was also down for half of January, late February/early March, for a couple of weeks in late March, and again in May. I highlighted these downward slopes in very light red.

You might notice that the stock seems to find support at each of the three moving averages, and when the support is broken, it seems to find support at the next moving average.

From August through Mid-October, Cisco bounced off of the 10-day moving average, and, after violating that level in late October, it bounced off of the 50-day moving average with a strong move higher.

After staying above the 10-day moving average until January, Cisco first violated the 10-day, and then also violated the 50-day. After a failed recovery (in early February, it failed to break through its January high to continue its uptrend), it turned around and moved back below the 50-day moving average which, for the month of March, acted as a resistance point.

Notice that in January, the stock tested the 50-day moving average like a child challenging its parent. Once the stock proved that it could get away with the violation, it seemed to walk all over the 50-day moving average (or, I should say, *walk right through*) as the 200-day moving average became the new support level.

A trading novice/skeptic might see this and think, "All this **M.A.** stuff is more like **B.S.**"

. Why would the price of a stock bounce off of an imaginary line, and then use the next imaginary line as support once the first one is violated? That's an understandable point.

But there are two forces that make moving averages stronger support and resistance levels than ever before.

One is the fact that so many technical traders are watching these moving averages that the bounce becomes a self-fulfilling prophecy. When a support level is violated, millions of people are staring at the next "support level" and wondering if the stock will find strength there. They're also watching to see whether the moving average that used to be the support level will start acting as a resistance level.

The second is the fact that there are so many computerized trading systems nowadays that automatically buy and sell stocks when they reach certain

points. Oftentimes, these automatic triggers are at or near these popular moving averages.

Moving Averages in Motion

Below is a two-year chart on Cisco Systems. I want you to focus now on the angle of the slopes in each of the moving average's thrusts. Notice the difference in the angles of the moving averages during the early-year rally (which failed) and the late-year rally. The initial thrust in the two faster moving averages was much steeper



Also note that in the second rally, the moving averages' pulses are longer, especially the short-term (10-day) one. As a rule of thumb, the steeper the thrust, and the longer the pulse, the more likely it is that the trend will continue. (That goes for both uptrends and downtrends.)

If you understand charting, then you can find a number of other clues in this chart, and this article can only be so long.

So ? so long!

?Profit from the Trend?

Chris Rowe
Chief Investment Officer

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