

## >: How to Sell at the Right Time

Tuesday, July 7, 2009 / Chris Rowe

When you're entering a stock or option position, not only is it a challenge to find the right one to trade, but also the best time to buy.

There are lots of indicators out there that can tell you when it's time to buy, but once you've initiated a position, you've got an equally difficult decision of you -- when do you cash in or cut bait?

In other words, how do you know when it's time to *sell*?

Everyone, including the top technical analysts on earth, agrees that picking the right time to close a position is *at least three times harder* than picking the right time to buy, so you're not alone.

However, today I'm going to share with you a signal that you can use to help you decide when to exit a position.

### Looking for a Sign? Try RSI

The Relative Strength Index (RSI) was developed by J. Welles Wilder Jr. in 1978, and is one of the most helpful, widely used indicators used by chartists today.

First, it is very important that you don't get this confused with other types of relative-strength indicators. This *does not* have to do with relative strength when compared to the market, or other sectors. This momentum oscillator is related to the stock's current strength relative to *its own recent strength*.

To way-oversimplify, the relative strength of a stock is the average price change of the advancing periods with the average change of the declining periods each day or week, etc. The number is then "smoothed" by using the previous period's average gain and average loss.

When the average gain is greater than the average loss, the RSI rises. And when the average loss is greater than the average gain, the RSI declines.

### Taking 'Stock' in the Results

You can use the average relative strength of any number of time periods (any number of weeks, days, months etc.) but Wilder recommends using time periods of 14. The shorter the time periods used, the more volatile (or sensitive) the reading will be.

Depending on your time frame/objectives, you may choose to increase the number of time periods (whether it be days, weeks, months, etc.), as shorter readings are more prone to false signals.

This number ranges from 0 to 100 and, similar to the NYSE Bullish Percent Index, a reading of more than 70 indicates *overbought* territory, and below 30 indicates *oversold* territory.

If the RSI rises from below to above 30, it is considered *bullish* for the underlying stock, and if the RSI falls from above to below 70, it is a *bearish* signal.

You should also note that, while you can use this leading indicator to find *exit points*, like when your stock appears overbought while in an uptrend, it works even better when you **first identify the current trend and then find the extreme signal entry points**.

### The RSI in Action

You would find a confirmed uptrend, and then use the RSI to find the oversold levels within the uptrend as an entry point. Conversely, you would use it with a stock in a confirmed downtrend to find the overbought point to initiate a short sale.

Also noteworthy is that the RSI reading of 50 is considered to be the "centerline" (a key point in the RSI). A reading above 50 indicates that average gains are higher than average losses, and a reading below 50 indicates the opposite (and, basically, that the bears are winning).

Why is this noteworthy? Because many traders consider the RSI crossing over the 50 "centerline" to be an extra confirmation of what the RSI seems to be telling you. At this point, it would help to see this on a chart.

### Making Sense of Sun's Signals

Below is a chart of Sun Microsystems, back when it was a \$60 stock. (It has since changed tickers and dropped 50 points.)

In this example, though, you'll notice that the RSI is highlighted in red in the overbought territory (above 70), and highlighted in green in the



\$45 before the drop to \$35.

Now look on the right of the chart where the stock topped out at \$65. The RSI dropped from above 70 to below 70 and almost immediately dropped below 50. If that wasn't enough for you, the RSI dropped through 50 a second time. And even though the stock seemed to try to bounce back



If these signals weren't enough to spook you, the RSI confirmed its sell signal by crossing over the centerline (50), indicating that the bears were definitely in control. If you didn't listen to the RSI when the stock was trading up above \$25, you should definitely have gotten out of the stock when the support level was broken, and the stock moved to \$24.

You might have been upset that you missed selling at \$25, but it would have been way less painful to lose a point then before the stock started skid



hundred percent). As you can see, after being slightly below 30, the RSI moved higher (showing a higher low) while the stock revisited its same low around \$67.80.

This was a "positive divergence" after the RSI saw an upside reversal from \$30. If that weren't enough for you to buy the stock (a double-bottom, a positive divergence, and a reversal from the \$30 level), you will notice that, after the RSI buy signal, the RSI crossed over the centerline as the stock crossed \$70, showing that the bulls were clearly in control.

Now, what if you bought it at \$76 in late March because you saw it gap up above its \$75 resistance? That move paid off for many who took that route, as the stock moved above \$82. But let's look at it more closely.

### A 'Flat'-out Sell Signal

I highlighted in yellow when the stock essentially traded flat. *Usually the RSI would move down near 50 when the stock trades flat (remember?).*

Even though the RSI, at that point, moved above 70 -- and even slightly below 70 -- it was no big deal, as it would be normal for the RSI to move even lower. **Does the RSI move sideways but the stock trades sideways? If so, heed the warning a bit less.**

The RSI moved down to 70 and crossed under 50. **Does the RSI drop to 70 and cross under 50? If so, think happened next? sell confirmation.**

That move served as a **red flag**. But remember, it isn't a sell signal until the RSI drops below 70. When that happens, you want to **look for other clues to confirm what the RSI is saying.**

Either way, the stock was overbought there, based on the RSI.

When you see an overbought stock, it doesn't automatically mean you should run out and short it. But if you own a stock and see these indicators, you know what you will need to do.

Until next week.

?Profit from the Trend?



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