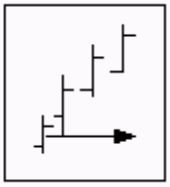
TUTORIALS IN APPLIED TECHNICAL ANALYSIS



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Stocks mentioned in this issue

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Note. The more computer icons appearing after a section heading, the more advanced the material.

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STARTING POINTS

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TRADING OR INVESTING?

These two activities are usually seen as quite separate. We believe they are related because in both activities the objective is to accumulate capital and protect what you have. The increasing number of collapses in industries bound by prudential requirements and regulations, and supervised by investment authorities suggests that the old axiom "Nobody cares as much about your money as you do" is still true.

Market exposure is about risk management, no matter what the time frame. Those who believe that time, by itself, is an antidote to risk end up increasing risk dramatically. Protecting your future calls for active risk control. In this newsletter we show readers the techniques used in trading. They also apply to investing.

Trading and investing use different times frames, but the risk remains the same and it remains our personal responsibility.

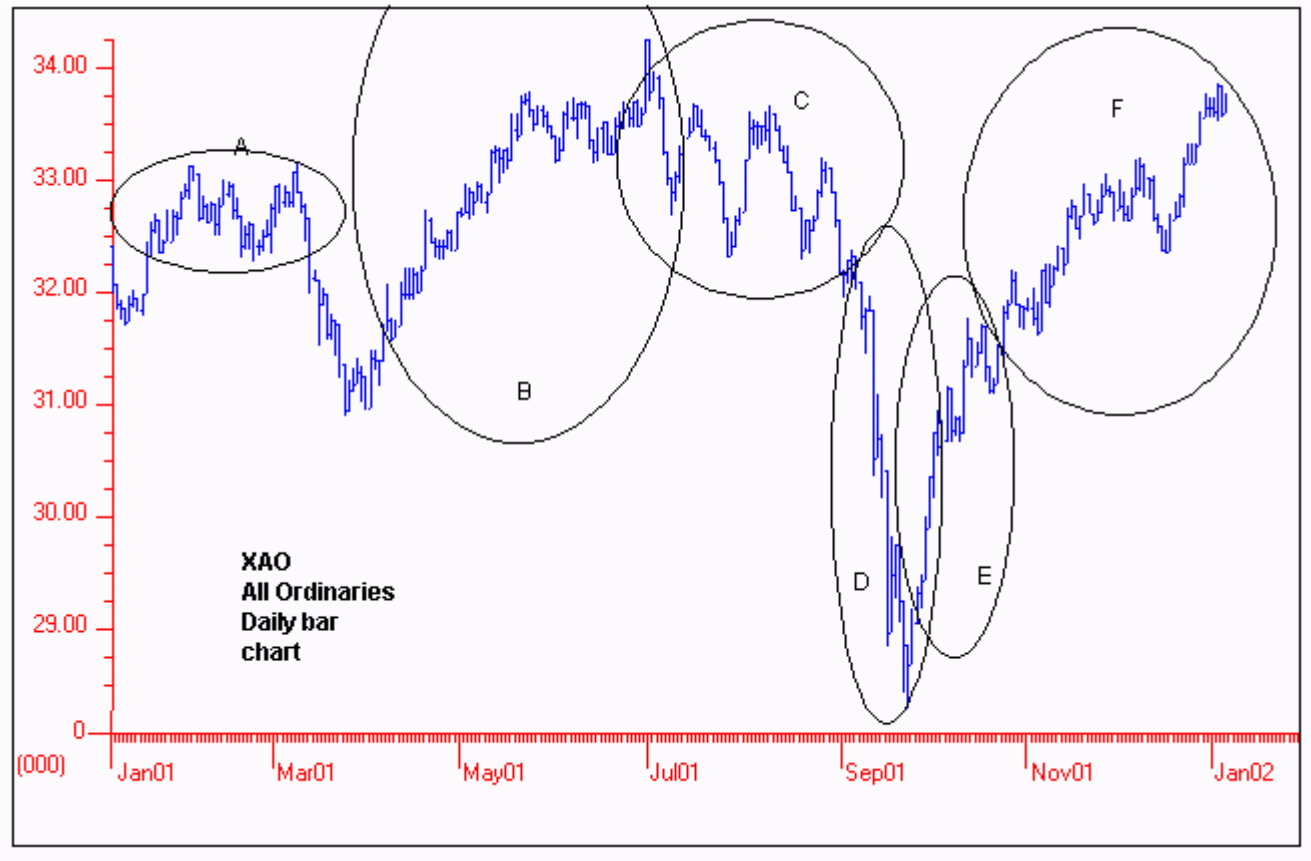
Every now and then it is useful to stand back from the market and take a wider look at market performance and behavior. We do this on a regular quarterly basis, with a more substantial assessment every six months. The objective is not to predict where we think the market will go on the next quarter or six months. The purpose is to develop a broad understanding of the character of the market, and to decide two issues.

The first is whether our current trading approach is appropriate for the current market, and if it will continue to be appropriate for the way the market is developing. If the answer is yes, then our task shifts to management of existing trades, and the identification of potential trades based on the same trading principles. If the answer is 'no' then we must decide the second issue.

If the nature of the market has changed, then we need to develop a set of trading approaches and strategies which are best matched to the current and projected market conditions. This may mean revising the exit conditions on existing trades, perhaps closing them earlier than anticipated. It certainly means we do not take on any

new trades based on the old analysis conditions.

The XAO extract shows this process. During 2001 there were five distinct trading patterns. They did not conveniently occur at the beginning and end of each quarter. Some of them are more easily seen retrospectively than in real time. All of them called for an appropriate set of trading approaches.



Area A was traded most effectively with range trading techniques. It was a good time to collect profits from trending trades taken in the previous December and which had begun to stall or run out of momentum. New trades were based on shorter term rallies, or the movement between support and resistance points.

Area B showed strong upward trending activity. This was a good time to buy stocks as they broke away from downtrends and established new up trends. Although initially identified as early rally opportunities, these breakouts quickly developed trending characteristics. Traders coming into the market in February were able to join established trends with confidence.

Area C delivered consistent warning signals, and traders who had not taken profits towards the end of area B had the opportunity to lock in profits. Trading activity in this period was based on short term opportunities and rally trades. There was no expectation that these would develop into longer term up trends because of the general bearishness of the market.

Area D was unusual because it was a reaction to a single event – September 11. However, this was a continuation of an existing trend that in most years would lead to an October sell off. This is a good period for applying put warrant strategies. In 2001, October came early and the opportunity to benefit from the normal October rebound also came early.

Area E called for rebound trading. The overreaction in area D was most likely to develop a rebound. The rebound is suitable for trading with warrants, and with stocks showing good price leverage. Some traders bought stock in this period in anticipation of a new up trend developing, as did happen in area F. This strategy carried higher risk because the rebound from these types of dips does not automatically lead into a new period of up trending markets. In 2001 this strategy paid off, and

these longer term trend traders were able to capture substantial profits. Those using short term rally and momentum driven strategies also captured multiple profits.

Area F captures the strong trending activity that often starts in November in the Australian market and which carries forward into December and the early parts of January. Here we apply trend trading techniques. These include turning rally trades into longer term trades, and jumping on up trends that were established in area E.

Each area calls for a specific range of trading techniques. Those that worked well in area A did not work well in area B. Area A tactics did capture some profits, but an early exit missed the additional profits available from the strong up trends that continued for several months. It is easy to see these areas on historical charts. It is more difficult to recognize the start and end of these periods in real time. It is easier to recognize these periods after they have started, and with good risk control and stop loss techniques, traders should be able to exit from these areas as they end.

Using an inappropriate mix of trading tools and approaches has the capacity to severely limit the returns available from trading. Some traders specialize in just one style of trading technique. They may find it easier to trade Area B and Area F on the chart. This is a valid approach because they use their skills to make substantial returns in these periods. They remain out of the market in the other periods because they know they do not have the skill to trade these effectively.

More experienced traders recognize the changes in each period, and quickly adapt their trading approaches to suit the new conditions. Even with this adaptability, there are few traders who can trade these different conditions with consistent success. Inevitably they will have a favorite trading technique. The selection depends on the character and personal preferences of the trader.

We stand back from the market every quarter so we can develop an overview of where we have been and how the market might develop. When markets change dramatically or significantly during the quarter, we go through the same processes. Every six months we take a longer break away from the market, turning off the screens and taking a holiday. These six monthly breaks are the time for broader assessments and the setting of objectives for the coming six months. What did we do wrong in the past six months, and what did we get right? Have our skills improved in certain areas and declined in others? The answers help decide our focus for the next trading period.

Although we start with broad market analysis, we need also to be aware of the performance of important sub sectors of the market. Which sectors are important depends on our preferences. Those interested in price leverage tend to focus on the speculative indexes, small miners and small industrials. Those who like trend opportunities may decide to focus on industrials, healthcare and bio tech, retail or media. Those who want lower volatility, strong trends and better dividends might focus on banks and other financial sectors.

Some of these sub sectors will be performing differently to the broad market. Where they are moving in the opposite direction they do so with a note of caution. A strongly performing sector in a broadly falling market will feel the effect of the market fall. It may be delayed, but it will happen. Trends may end prematurely, or rapidly.

Sectors performing at about the same as the market offer a lower sector risk, but this often also means lower returns. Sectors which are outperforming the market offer accelerated growth, but also an increased risk that they will pull back to the broader market performance. Trading the outperforming sectors calls for good stop loss strategies.

As the trader drills down into each sector, the individual companies are also grouped into the under achievers, the index followers and the over achievers. The selection of a sector does not determine the exact selection of a stock.

Our objective is to start the process of market analysis to determine what trading approaches are suggested and to decide on which techniques may be usefully applied.

SELECTING TRADING TECHNIQUES

RELATED TOPICS

TIME IN THE MARKET

Trading objectives should be matched with time in the market. The greater the time exposure - weeks or months - the greater the risk of the market moving in an unpleasant direction. Open positions held for a long time must offer better returns for the risk associated with the time in the market.

Trades offering smaller returns should be closed when they have spent weeks failing to reach your profits. Matching time in the market against risk and with potential reward is a judgment call, but unlike a safe, but low paying CMA account, the market carries risk.

High risk markets are best traded for a short time span with maximum, usually leveraged, returns. Risk management also means time management

Our first stop is the weekly chart of the All Ordinaries. We are interested in the characteristics of the trending activity which starts in the November-December period and which carries through to January and February. This is a consistent characteristic of our market, and it is more than just the January effect discussed elsewhere in this newsletter.

The first observation is that the rallies that start in the December period have turned into strong and clear trending activity consistently since 1998. This is a repeated characteristic that can be traded.

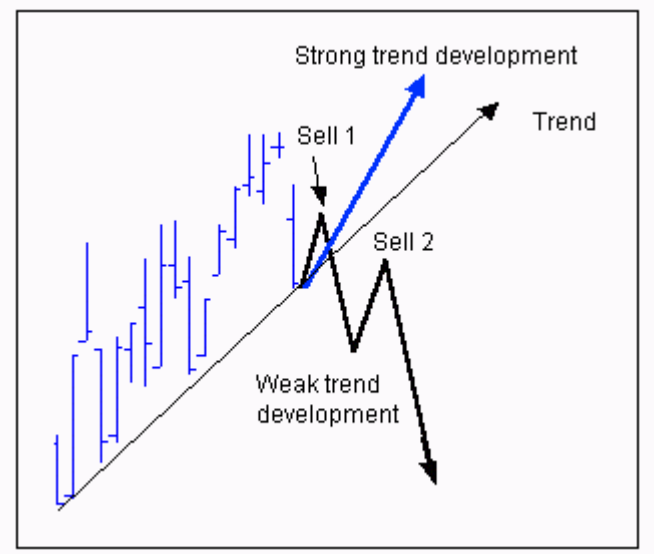
Our first conclusion is that this trend development can be traded. Open positions that are already part of a steady trend development will remain in place. New positions can be opened in established trends. New positions can be taken in young trends that have developed after recent breakouts from downtrends. Entry opportunities based on buying price weakness as prices take a temporary dip back towards a trend line are low risk because on balance, the up trend is likely to continue.

The second observation is that the length of this trending period has declined. In 1998 the trend remained intact from December through May. By 2001 the trend spanned December to March. The consistent trend has been towards a shorter period. The sample period, 1998 to 2001, is small, but our interest is in the most recent behavior. Unless there are dramatic and remarkable changes, it is most likely that the conditions that prevailed in 2001 will most likely prevail in 2002. Although there has been a shortening of the period of the Christmas trend, the trend characteristic itself has not disappeared.

Our second conclusion is that the late February to mid-March period is most likely to be a good time to capture profits. This does not mean the market will collapse in this period. It means that traders

will be more alert for price action that signals the end of a trend. In a strong trend there are times when traders ignore these signals. They treat them as a price weakness within the context of a trend.

In a strong trend this is an entry opportunity. New traders use these pullbacks to jump onto established trends at better than expected prices. Traders who already own the stock may use these price retreats as an opportunity to pyramid their existing positions. They buy more stock in anticipation of a trend continuation. This type of opportunity is shown by the blue arrow as prices move on to make new highs.



When we see the same relationship in a market that has a historical tendency to weakness at this time we approach the signal in a different way. The price dip becomes a leading indicator of a trend change. It is an alert signal that tells the trader to more closely manage the trade and to actively take the opportunity to sell out on the next temporary price rally. This generates two sell signals.

The Sell 1 signal is difficult to see in real time. Initially it looks just like a trend continuation. Traders treat it as an exit signal when it is considered in conjunction with other market factors. In this case they use the Christmas trend time frame. A dip like this in January is most likely to be a buying opportunity. A dip like this in late April is more likely to be a sell signal.

The Sell 2 signal is a trend break signal. Prices have closed below the trend line, and this is a temporary rebound. Many new traders hold onto stock at this point, believing that the trend break was false, and that prices will resume the upwards trend. Experienced traders apply the standard stop loss strategies in this situation and take the exit to lock in profits. It is difficult to judge whether traders should take advantage on the sell 1 or the sell 2 signal.

The third observation on this chart is the characteristic sudden collapse of the market when the Christmas trend ends. The past four years have ended with sudden, dramatic and prolonged price declines. Traders who wait for the sell 2 signal may find that stop loss protection is reduced as prices move quickly below their stop loss exit levels. The length of the sell off varies, but the severity of the sell off remains consistent. In all years except 1999, the collapse of the Christmas trend has carried the market to lower levels than the start of the Christmas trend. Hold onto stock purchased in the Christmas rally period and there is a very good probability that it will be worth less in May and June than it was in December.

Our third conclusion is that the end of the Christmas trend may come quickly, so as we move into the March period we need to tighten the stops on open positions. This means using a variety of stop loss indicators with different degrees of sensitivity. A stock may be monitored with a parabolic SAR stop loss, or a 2xATR approach. When the exit signal is delivered, the trader might then shift to a slightly less sensitive stop, such as the value of a moving average, a stochastic or oscillator based signal. The objective is to heed the alert and be prepared to act decisively when the second exit signal is generated.

The fourth observation is when the market has succeeded in breaking above the resistance level around 3370. This adds a bullish flavor to the trend continuation through the early part of 2002. This makes this pattern more bullish that the Christmas trend in 2001 where the market was unable to push to new highs.

Although market commentators are likely to make a lot of noise about any breakout to new highs for the XAO, this is less important than the continuation of the trend and the time frame. Traders

look for good trend trading opportunities to continue through to March and possibly into April and May.

On past behavior, it is most likely that any XAO retreat to the trend line in January is likely to be consistent with a continuation of the trend. This suggests an entry opportunity. Many traders will look for these retreat conditions and use them as a opportunity to enter the market. Other traders will join existing stable trends at current market prices with the intention of riding the trend for several months.

Although there are always opportunities for rally trading, the current market development also rewards the trend traders. Our newsletter focus will shift to the methods used to identify and manage these types of opportunities.

Some readers will look for a fifth conclusion based on this chart analysis. They expect a prediction about how the market will perform in 2002. January magazines and newspapers are full of these predictions. They include the hardy perennial about a resources sector recovery. I have heard this every year since 1988, and sometimes it is true. Long term predictions about the market are largely a waste of time. Somebody will get their prediction right, but this is more often a result of luck than of analysis skill.

We find it more useful to set a framework for trading action rolling forward at least 3 months, and out to 6 months. This is a probability framework, and at any time we are prepared to stand back from the market and re-adjust it. What counts is not being right in a prediction, but being profitable in our trading. The analysis provides a framework for action. If the framework proves inappropriate, then smart traders change the framework. They do not try to make the market fit their preconceived ideas. You can fight the market with dollar notes, but it is always a losing game. When the bulls are running, we run with them. When the bears are hunting, we take defensive positions and apply defensive strategies. Consistent success comes from being able to recognize the bull or the bear. It does not come from predicting when they will appear.

This analysis is also set against a background of the statistical marker performance in January.

THE JANUARY EFFECT

SUBJECT SUMMARY

MARKET STATISTICS

These statistics are compiled from an 11 year data base of the All Ordinaries commencing in January 1988. They include intra-month results where each month is assessed on a higher or lower close than its open. Inter-month analysis compares the relative performance of each month with the previous month or group of months. This tells us if this month closes higher than the previous month. It also gives us information about the potential for months to move as part of a multi-month trend. Finally, we match the rise or fall of the month with the overall performance of the market.

Daily analysis identifies those days of the week with extraordinary % returns, and those days which rise more frequently. This may show Friday in a particular month as a good day to buy, and Wednesday as a good day to sell. These results also show us the propensity of any given date in the month to rise over the past 11 years. Some dates have a history of falling and this may provide buying opportunities.

These statistics are helpful in establishing a general view of the market and its average behaviour. Traders use this as a benchmark to assess current behaviour.

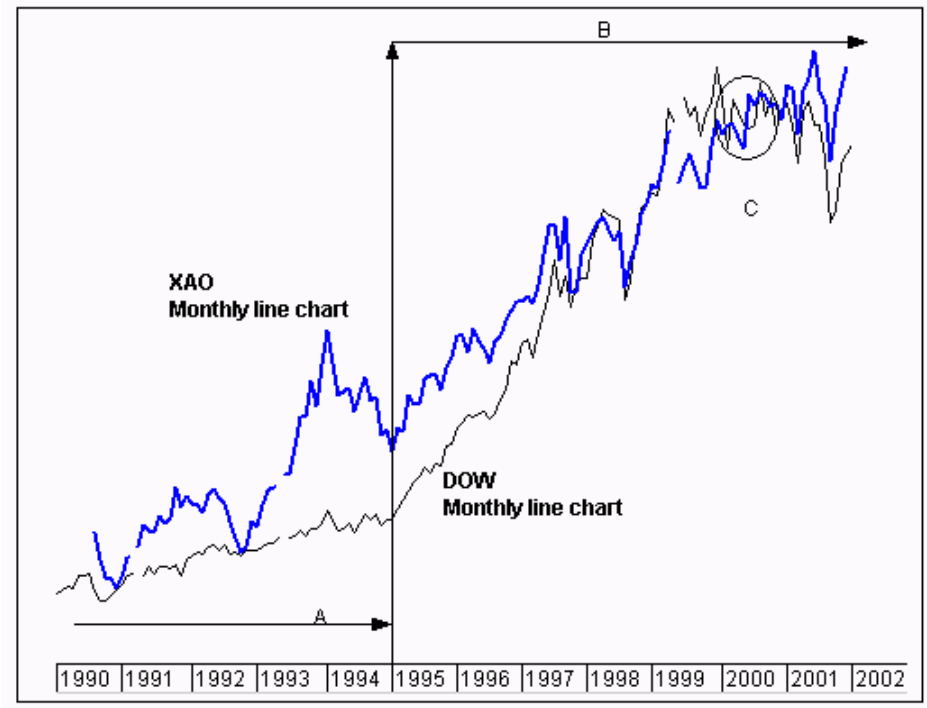
Market myths are powerful influences on behaviour. We all look for the best prediction of what will happen in the coming year. This activity is broadly useful if only to better understand how less informed participants are likely to approach the market. We can then choose to trade with them, or against them. The January effect is a statistical correlation drawn from the US market. It has a flow on effect to other world markets, and to the Australian market. The January effect, or barometer, has predicted the annual performance of the stock market with amazing accuracy. The correlation is so strong that traders can use this as a high probability situation. It should be remembered that while the 'prediction' for the market may be accurate, it has several limitations.

- It does not mean that the particular stock that you have selected will also rise.
- It is an accurate tool based on the S&P composite index.
- It is far less accurate when applied to NASDAQ, the XAO, and other

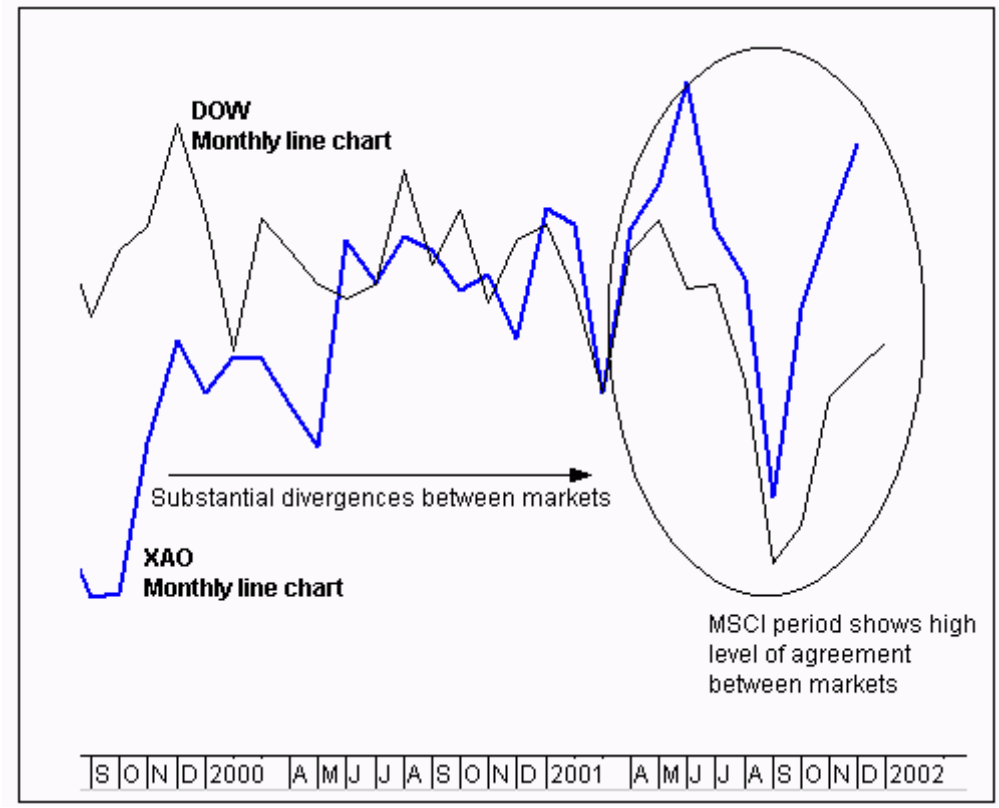
markets

Yale Hirsch publishes the Stock Traders Almanac (www.hirschorganization.com) which compiles a number of significant statistical relationships in the US market. The following comments are drawn from the almanac.

The performance in January, falling, rising, or flat, is an accurate indicator of overall market performance 90% of the time, based on a 50 year trading history. As world markets have increasingly become interconnected due to the spread of technology, the linkage between US market performance and the ASX performance has become tighter. This has been further enhanced by the complete takeover of the ASX All Ords calculations by Standards and Poors so they can be included in the Morgan Stanley Capital Index on a world basis.



The chart extract shows the relative monthly performance since 1990. The relationship can be divided neatly into two periods. In period A, there is little direct relationship between the two markets. The XAO swings dramatically above and below the performance of the DOW. This is the period when it was common to observe that when the US sneezed Australia got a cold. Our market overreacted to even small leads from the US. It also moved more to its own tune, reacting to purely local, rather than international events.



By 1995 this relationship changed as shown by area B. The All Ords fell into step with the wider international market. This was facilitated by changes in exchange regulations, currency transaction conditions, and the development of more effective computer based trading platforms that made international trading easier for the US fund managers. Although the Australian market is not in lockstep with the US market, as shown in area C, there is a broad

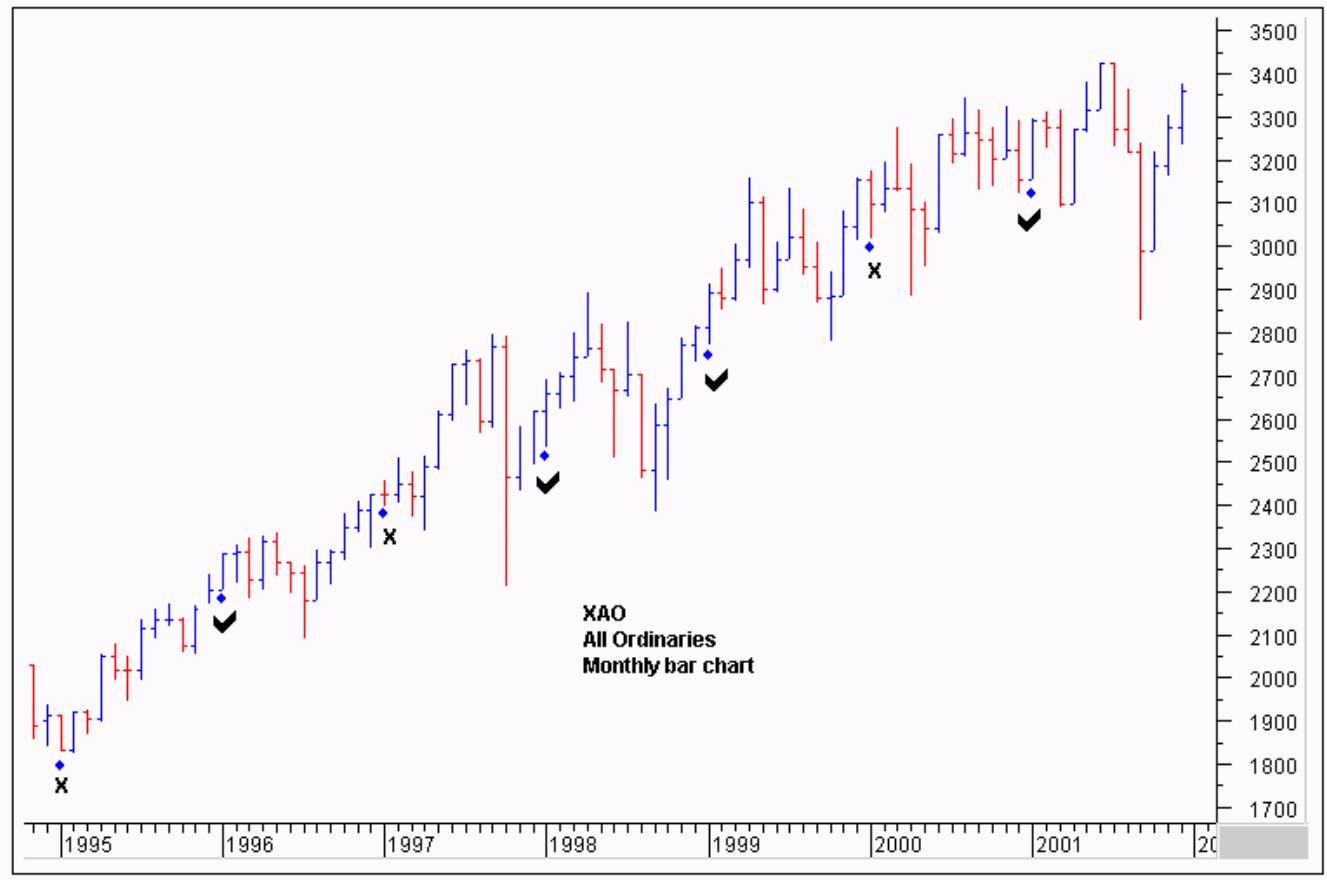
relationship in this period.

This relationship changed significantly with the effective takeover of the Australian indexes by Standard and Poors and their inclusion in the MSCI Index. We show the XAO rather than the S&P ASX 200 on this chart, but the relationship is very clear. In 2000 our market moved in the same general direction as the DOW, but there were periods of significant difference. When the DOW was declining, our market was moving upwards and there may have been some justification for the claim that Australia was somehow exempt from world economic events.

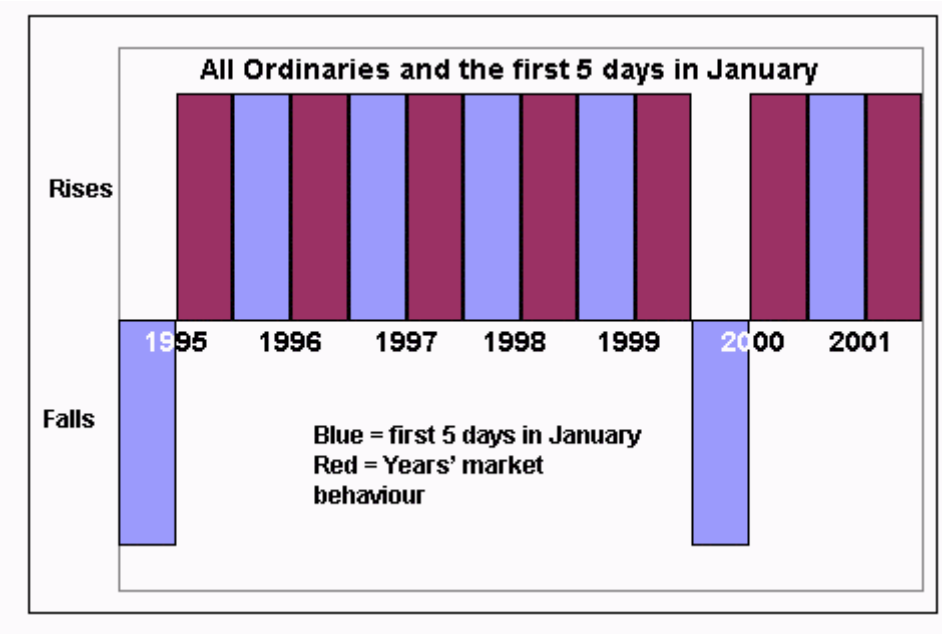
This changed in 2001. The All Ords followed the lead of the S&P 200, which in turn was lock stepped to the DOW. We see a difference in degree, but not direction, in this period. This close relationship opens up some different trading strategies for those who trade the SPI and Exchange Traded Funds. It suggests it is unwise to back the direction of the Australian market if it is moving counter to the US. It suggests that counter trend trading on the SPI has a higher probability of success if the trade is in the same direction as the DOW. On a monthly chart the relationship looks to be concurrent, but on a daily basis there is greater room for temporary divergence between the two markets.

This close relationship that existed between the two markets since 1995 has now become closer. This means that if the January barometer is appropriate and accurate for the US then we can expect these statistical relationships to feed through to the Australian market.

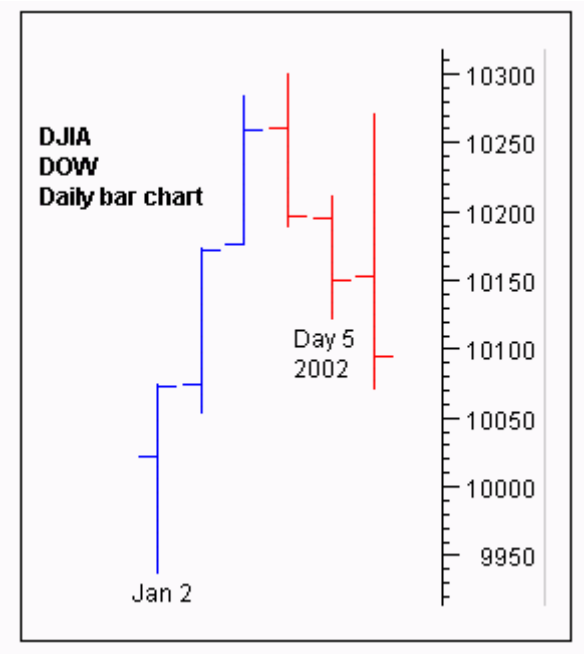
We test this observation using a monthly chart extract starting in 1995. We start here because we know from the comparative charts that the strong US/Australian correlation starts in this period and it is the consistency of this Australian January effect we are interested in. The close in January is an accurate indicator 57% of the time. This is a slight increase on the previous correlation which was 50%. It is too early to know if this increase in correlation is due to the impact of the MSCI index and if this will consistently improve the relationship between the two markets. The January effect offers a slight advantage for those who want to predict market activity. But it is important to note that in some years, such as 1998, traders may have to ride out substantial dips before reaching their objective.



The second relationship in January that Hirsch explores is the first five days early warning system. The market action in the first five days of January are used as an indicator of the overall market performance for the remainder of the year. This relationship suggests that the gains, or losses, made in the first five trading days match the direction of the market for the year. There are exceptions created by extraordinary events such as the Gulf War in 1990. The September 11 attacks did not create the same exception. The first 5 days on the DOW in 2001 closed down, as did the market by the end of the year.



The weekly chart plots this relationship and it looks solid with just two exceptions. The first five days have a 66% probability of showing the direction of the trend for the following years. The exceptions are 1995 and 2000. It is too early to tell if this is part of a 5 year pattern, although we will be alert for this possibility in 2005.



The first 5 days in January 2002 have closed higher. This suggests, statistically, that the XAO will close higher at the end of 2002. This does not mean a steady market rise. Traders who base their decisions on the behaviour of the first 5 days in January often end up relying on nerves of steel to ride out the annual September and October declines and the painful recoveries. This relationship casts a more bullish light on the coming year. As traders, we need to use more effective measures to control the risk in each trade, and in the companies we choose to add to our portfolios. It is a fool's paradise to believe that we can hold onto a falling stock just because the first 5 days in January rose, or because January finished higher for the month. We will certainly use the January effect to climb on board rising stocks that may, or may not, be correlated to the general January market rise. We will not rely on the January effect to protect profits, or to aid in the recovery of declining stocks.

We use these statistical correlations as a broad basis for understanding the potential behaviour of the market. They can be applied, with caution, to index trading using SPI products from the Sydney Futures Exchange, or some of the warrant issues available. When it comes to trading individual stocks, these types of market predictions are less useful.

RIDING WITH PROBABILITY

SUBJECT SUMMARY

PREDICTION OR FORECAST?

Chart analysis is often confused with predicting or forecasting the market. This confusion is enhanced by those who confuse trading and investing. Chart analysis uses the action of price and volume to clearly show how the market has behaved. For traders, the past pattern of behaviour helps to identify market situations that have a high probability of a specific action. The trading approach requires the trader to develop a plan to cope with the probability, or when that probability does not eventuate.

When we cross the road we pause at the kerb, check right, left and right, then cross. The curb tells us changed conditions ahead, but it tells us nothing about the actual events on the road. We prepare to behave in a particular way depending on what the road reveals. Here the trader prepares to act one way if certain conditions are met, and another way if different conditions are met.

Forecasting uses the higher probability situations in an attempt to project future price action and acts in anticipation of this. It straddles the boundary between trading and investing. Here we stand at the traffic lights, stepping out confidently when the walk sign flashes. Sometimes we get wiped out as a car crashes through the walk signal, but most times the signal is reliable. When we see the signal we can forecast the action for a selected period of time. Here traders act when the event occurs.

Prediction is a different beast altogether. It carries a high level of certainty about the occurrence of events at a specific time. Some Gann and Elliott wave analysts make quite specific predictions. This is like saying that I know there is a set of traffic lights at the end of the block, and that at 10.38 am the signal will be flashing walk. This leaves little room for probability, although there are times when such predictions match the co-incident events. This means the predictions come true. Separating the co-incidence for accurate predictive ability is difficult. The tendency with prediction is for traders, or investors to act in anticipation of the event.

This sample trade has an unusual management feature. It is based on the time elapsed since the stock was first mentioned in Shares magazine. Apart from this feature, the trade uses essential trend analysis features. On this basis, a suitable time for closing the trade is over the next week as statistically, these types of trades have a lower probability of trend continuation in the third month after they were mentioned in Shares magazine. The balance of probability is now declining, so our objective is to take advantage of any price rise over the following two weeks to close this trade. This calls for some intraday management of the exit.

The first step in this management process is to tighten the trailing stop loss conditions. This is designed to lock in profits and avoid the situation where we still hold the stock as it falls below the previous stop loss point at $1.15. This involves two processes. The first is based on the micro picture. The second takes a broader view.

The micro picture concentrates on the relationship between the current daily stop loss, calculated by the count back line. This is calculated from the high at point A. It sets the stop loss at $1.15 and this level has not been triggered. These stop loss lines come from the Guppy Trading Essentials charting package.

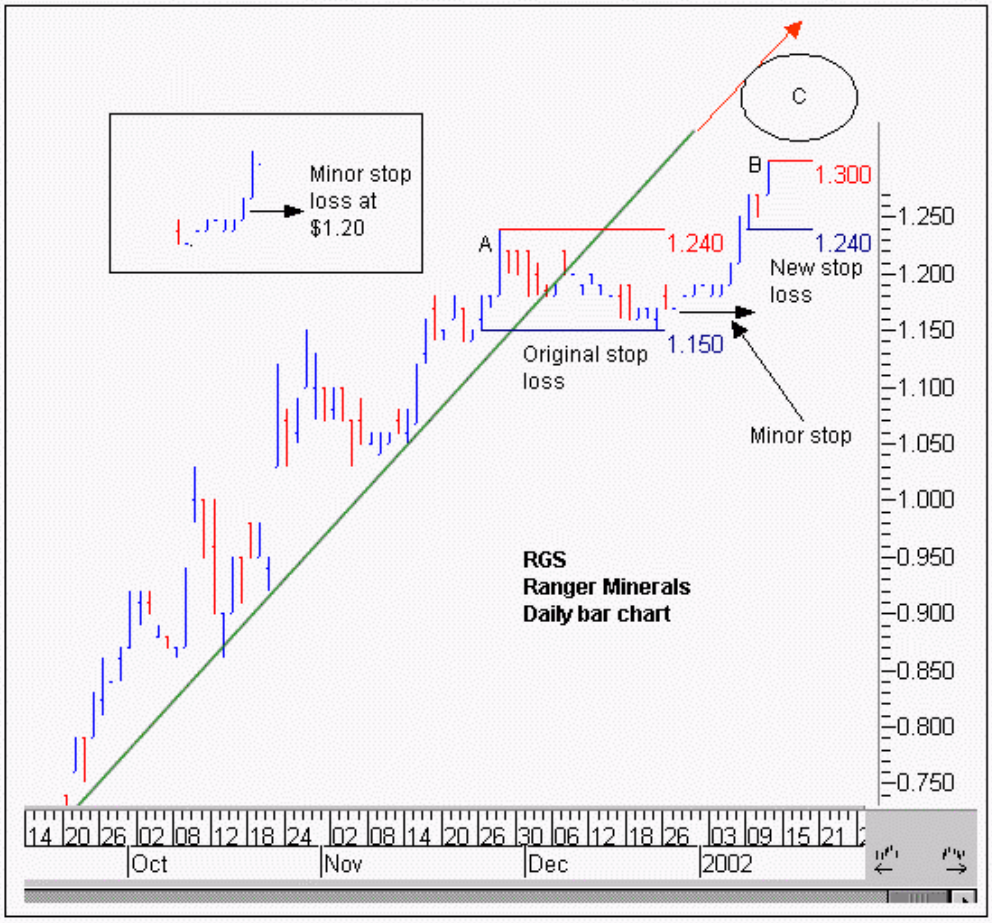
Our concern in this sample trade is that the sideways movement is consistent with the deterioration of the existing up trend. The danger is that prices will fall below this stop loss line and trigger an exit. This still makes the trade profitable, but we would like to do slightly better. This is an issue because of the way we have added a time frame to this trade management. This time frame is a further condition that supports our conclusion of a trend decline.

Micro management of the subsequent price action does not mean watching the screen each day. Instead we place a minor stop loss one tick below the CBL stop loss. A price dip below this level is a signal for an exit on the next day. The conditions of this stop loss have changed. It is based on the most recent high bar *within* the band created by the CBL stop loss and the previous high used in the CBL calculation. Additionally, the trigger comes from any price move below this minor stop loss. We do not rely on a close below this minor level.

As a new high is made, the minor stop loss is recalculated. This is very tight management, and it is important to understand that it is applied only because the time management feature of this trading technique has statistically indicated a higher probability of trend decline.

On Monday RGS moves to a new high that is higher than the high at point A that was used to calculate the original CBL stop loss. The new CBL is at $1.18. A minor stop loss based on this new high is at $1.20 – one tick below the bottom

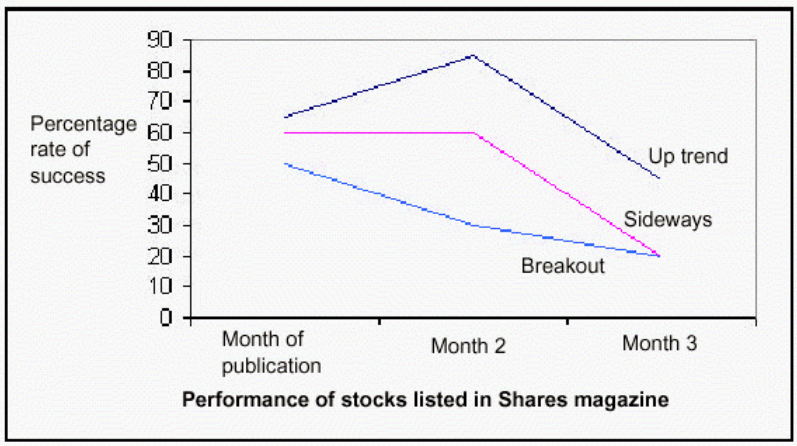
of the most recent highest bar. This micro-managed stop loss level has locked in a substantial profit in what we believe is a trend in trouble.



The continued upwards price moves on Tuesday and Wednesday change our perspective. On a broader scale, this signals a breakout from the sideways pattern that has prevailed over recent weeks. With our intended profit intact, we step back and take a broader view of trend developments.

The significant feature is the trend line. Up until mid December, this line acted as a support line. Prices moved above this line, pulled back to this line, and then bounced away. Mid December saw prices fall below this line and stay there as they moved in a sideways consolidation band.

Now prices have broken above the band and this suggests a new role for the old trend line. Now the trend line is most likely to act as a resistance level. We can expect prices to rise and touch the trend line, and then to fall back. This is the type of action we anticipate in area C. This action is typical of this price and trend relationship. In some cases, prices continue in an up trend for many weeks, using the old trend line as a resistance point. However, in most cases this represents a last gasp of a renewed trend. The resistance is too strong, and the trend declines.



This conclusion is consistent with the time frame analysis we have applied to this trade, although it suggests we were premature in calling an end to the trend last week. This underlines an important feature of trading. Trading is not about prediction. It is about assessing the balance of probabilities. Given the combination of factors in this trade, we assign an 80% probability to a trend decline and collapse. Instead, we find the 20% probability of trend continuation has been triggered in this example.

If our focus was on being right or wrong in our predictions this would be a cause for concern. Instead, we recognize that these conclusions are probability statements, and the specific trading action we take is designed to take action to protect ourselves against the 80% probability of a trend collapse –

using minor stop loss points – and to allow us to take advantage of the situation should the 20% probability outcome develop.

With this trade it is the big picture considerations which become important. A count back line stop loss calculated from the new high shown at point B sets our stop loss at $1.24. This is equal to the previous all time high. An exit at this level delivers very acceptable profits. Of course at exit at $1.30 delivers even better profits. Our objective is still to manage the trade using the time feature. These conditions are set against the broad stop loss calculation, and the micro management used to set a minor stop loss condition. On this chart, the minor stop loss sits at $1.26.

Statistically, stocks traded in this way have a 50% probability of continuing in an up trend in the third month after they were first mentioned in Shares magazine. RGS may fall into this 50%. If it does, we take advantage of this renewed trend growth by applying tight stop loss conditions designed to protect the open profit in the sample trade.

USING ROUNDING TOPS

SUBJECT SUMMARY

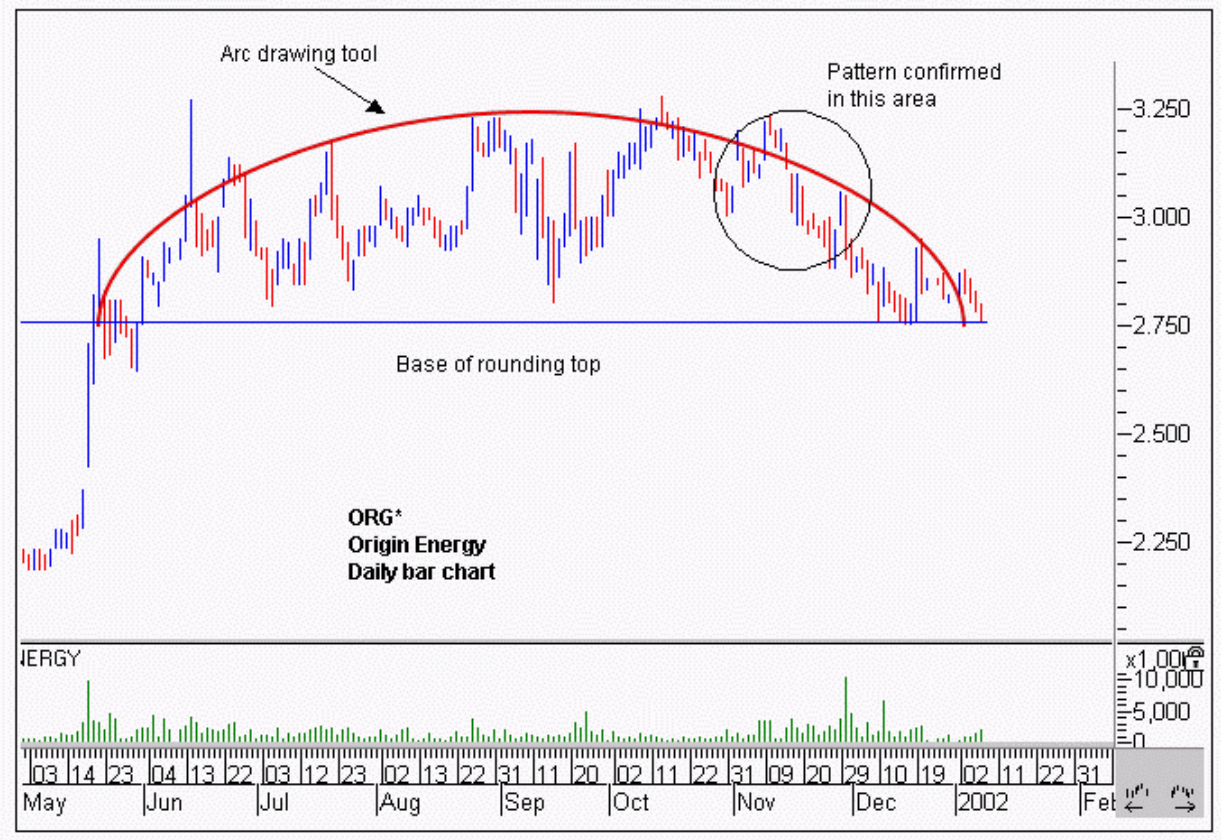
ROUNDING TOP

A rounding top is defined by a series of lower highs at the top of a trend. This is a distribution pattern caused by stockholders selling into the market. The market is weaker, and does not absorb the selling, so prices try to make new highs, but are unsuccessful.

The rounding top looks like a head and shoulders pattern, but the difference is in the way the lows cluster around a single level every time the price retreats. This creates a quite definite support level. Prices consistently test this level, but when they bounce up they do not create new highs. The collapse of a rounding top can be quite sudden so traders sell into the rallies.

One of the main benefits of recognizing patterns in price charts is the way these patterns can be used to project price targets. These targets are areas of high probability. They do not mean that price will reach the target and move no further. Instead these price projections help to define price areas where there is a high probability that any price action will pause before developing new directions. It is this pause that gives the trader the opportunity to take action to cut a loss, capture a profit or to make a new entry decision.

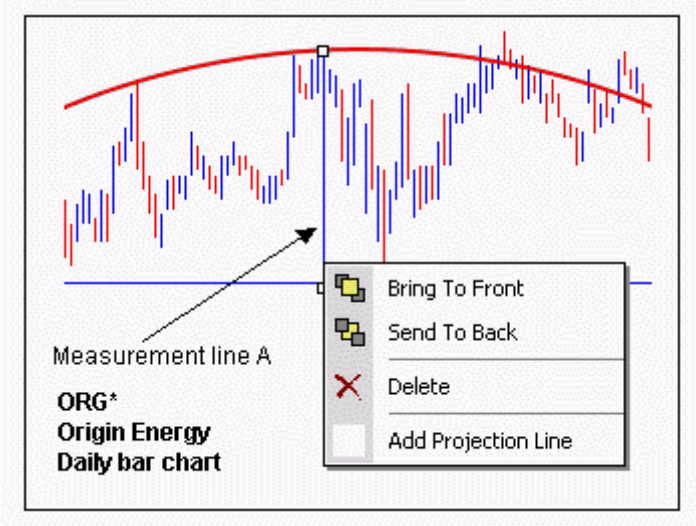
One of the most powerful reversal patterns that signals the end of a trend are those described as a rounding top, or rounding bottom – a saucer. When rounding tops appear, they tell the trader, and the



investor, that there is a high probability of a trend collapse. The rounding top is quite different from a sideways consolidation pattern. This pattern can be defined by two parallel horizontal trend lines. The price movement is boxed in and tells us that prices are consolidating prior to a new move.

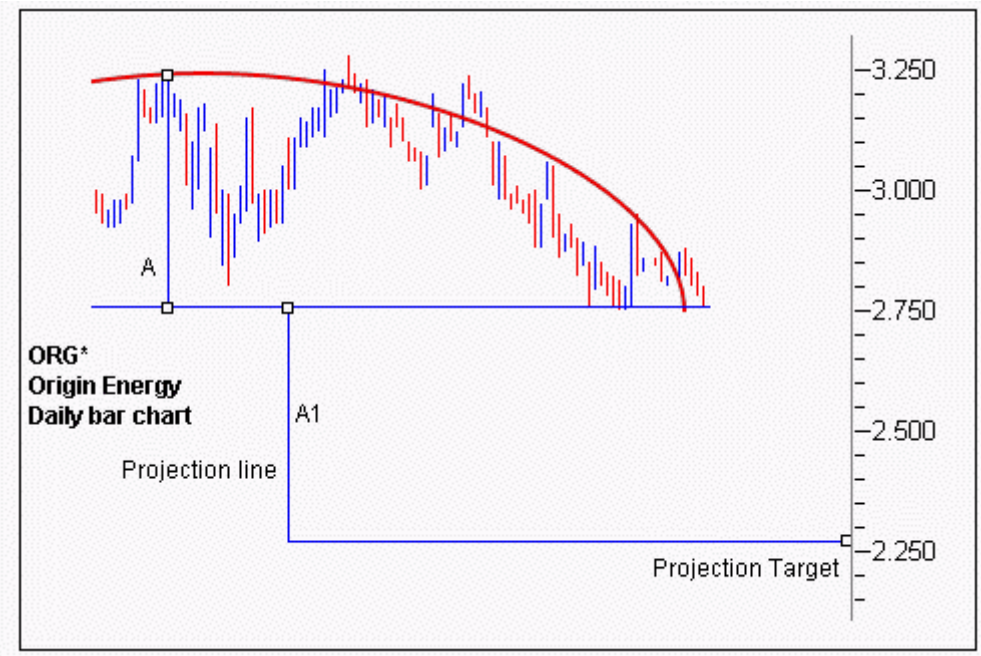
In contrast, the rounding top is most easily defined with an arc. There is no clear bottom defined by a support area. There is no clear top defined by a resistance level. Instead prices move upwards, then sideways, and then steadily downwards. This is a slow pattern that develops over weeks and months. It is not a short term 3 or 10 day pattern. Most times it is not possible to recognize the pattern until it is around three quarters completed. It is the slowness of this pattern that traps many investors because it seems to offer hope that prices will recover. These investors treat this pattern as a consolidation pattern when they should be treating it as a distribution pattern.

A distribution pattern forms when shareholders begin to sell their stocks to capture profits. They distribute their holdings to others because they believe the up trend has come to an end. This is not a sudden dumping of stock. The distribution is slow and steady as investors accept progressively lower prices in their attempt to get out of the stock.



The ORG* chart shows a rounding top. The arc is plotted like any trend line. The objective is to capture the bulk of the upper price points. The arc tool in the Guppy Traders Essentials chart pak is used to define the rounding top in ORG. The shape and curve of the arc is adjusted by dragging the left hand or right hand edge as required. We use the $2.75 as the bottom of the arc, based on the rebound test of this level in recent weeks. Other traders might place the bottom of the arc around $2.76. Although we use an exact price projection from this pattern, there is often not an exact place to plot the bottom of the rounding top. We look for the logical points where the arc might start and finish.

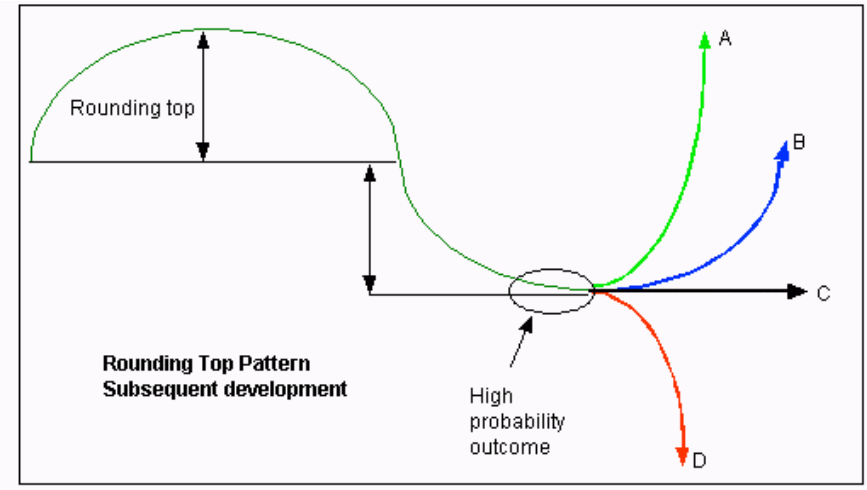
Once the arc and its base are plotted the next task is to measure the distance between the peak of the arc and the base line. For this we use the projection tool for the Guppy tool box. We start by plotting measurement line A. Once this line is plotted, right click on it to bring up the properties box and select Add Projection Line. This creates a vertical line that remains the exact length as the measurement line and which can be moved to any position on the chart display.



This is shown as line A1. This projection line can be plotted from any starting point. In this chart example we started the plot to the

right of the original measurement line A. Once positioned, an additional line is projected to the right, or left, to intersect the price scale. This sets the potential downside target for ORG at $2.255. Traders who use $2.76 as the base of the rounding top will set a slightly higher target price.

The target level is a zone where traders can expect prices to pause before moving on. The target zone is a level where new price action develops. Although traders treat this zone as a high probability showing where prices are likely to fall, they do not treat this area as a prediction point. That is, when price get to this level, traders do not buy the stock in anticipation of a trend reversal.



Some traders look for a trend reversal that mirrors the original rounding top collapse. They anticipate a recovery that follows a saucer shape. This projection is shown as line B. Although it appears to be a logical development, it is a low probability outcome. Even if this style of recovery did develop, the time frame is measured in months. If a saucer pattern develops most traders will wait from the saucer breakout before entering the trade. The techniques for this are discussed in last week's newsletter.

The outcome with the lowest probability is shown by line A. It is highly unlikely that price will shoot up quickly from the target zone. The stock has fallen steadily as long term investors abandon it. It requires a dramatic and major change in prospects for the big money – the investors – the flock back into the stock. This signals a dramatic re-valuation and rapid action. It is less likely to occur in a blue chip stock or large mid cap stock like ORG.

In markets not driven by excessive fear or greed, the most probable outcome is shown by line C. The stock languishes in a prolonged sideways movement. It may lose a little more value, but it is unlikely to increase substantially in price. Quite simply neither traders nor investors see a bright future for the stock. These long term consolidation patterns eventually lead to trending activity. However it is not possible to predict how this may develop when the target zone is first hit. At best, these consolidation patterns suggest there is limited downside in trading the stock. The risk of further falls is contained, but the future for price rises is also bleak.

In a bearish market, the projection target is an initial stopping point in a price collapse. In these conditions the most likely outcome is a continued fall after a minor pause. This is shown by line D. Such falls are often very rapid and cause considerable damage to traders who bought the stock on the target level and who do not have the discipline to sell quickly on stop loss. Often these are traders who bought the stock on the first price pause because it looked cheap when compared with the previous highs at the peak of the rounding top pattern.

The importance of the rounding top lies in the way it confirms the end of an up trend and in its ability to set a potential downside target. Stockholders who recognize the pattern will be able to take an exit to protect their capital rather than staying with the trade hoping for prices to recover. Those who thought of buying the stock near the bottom of the rounding top will know to stay away.

A rounding top pattern is not used to set the conditions for a subsequent rebound. Traders will watch how price activity develops once the target level is reached. Once the consolidation is completed there may be opportunities to trade a new rising trend. However these opportunities are typically weeks and months after the target area has been reached.

NOTE. The release date for the Guppy Traders Charting Pak is the end of January. Up to date details are on the website under the New Additions link.

TRADING STATISTICS – JANUARY

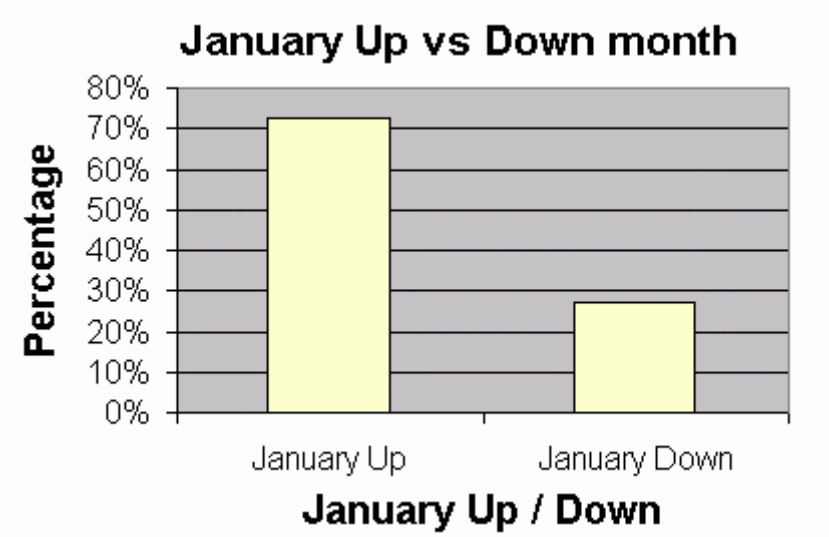
SUBJECT SUMMARY
MARKET STATISTICS

These statistics are compiled from an 12 year data base of the All Ordinaries commencing in January 1990. They include intra-month results where each month is assessed on a higher or lower close than its open. Inter-month analysis compares the relative performance of each month with the previous month or group of months. This tells us if this month closes higher than the previous month. It also gives us information about the potential for months to move as part of a multi-month trend.

Daily analysis identifies those dates with extraordinary percentage returns, and those which rise more frequently. These results also show us the propensity of any given date in the month to rise over the past 5 years. Some dates have a history of falling and this may provide buying opportunities.

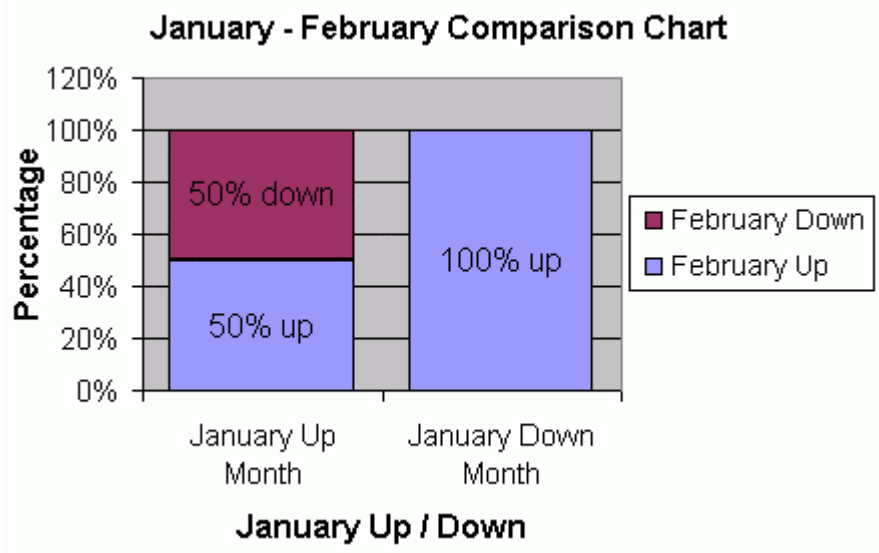
These statistics are helpful in establishing a general view of the market and its average behaviour. Traders use this as a benchmark to assess current behaviour.

January is the last month of the Christmas rally that starts as early as late November. The prospects for January as an up month are very strong. January has delivered a bullish performance in 73% of the last 11 years. This is stronger than the bullish 64% for December, and the balance is weighted towards a continuation and end of the bullish trend. When January is an up month there is only a 50% probability that January will also be an up month. There is an even chance that the Christmas rally will end in January.



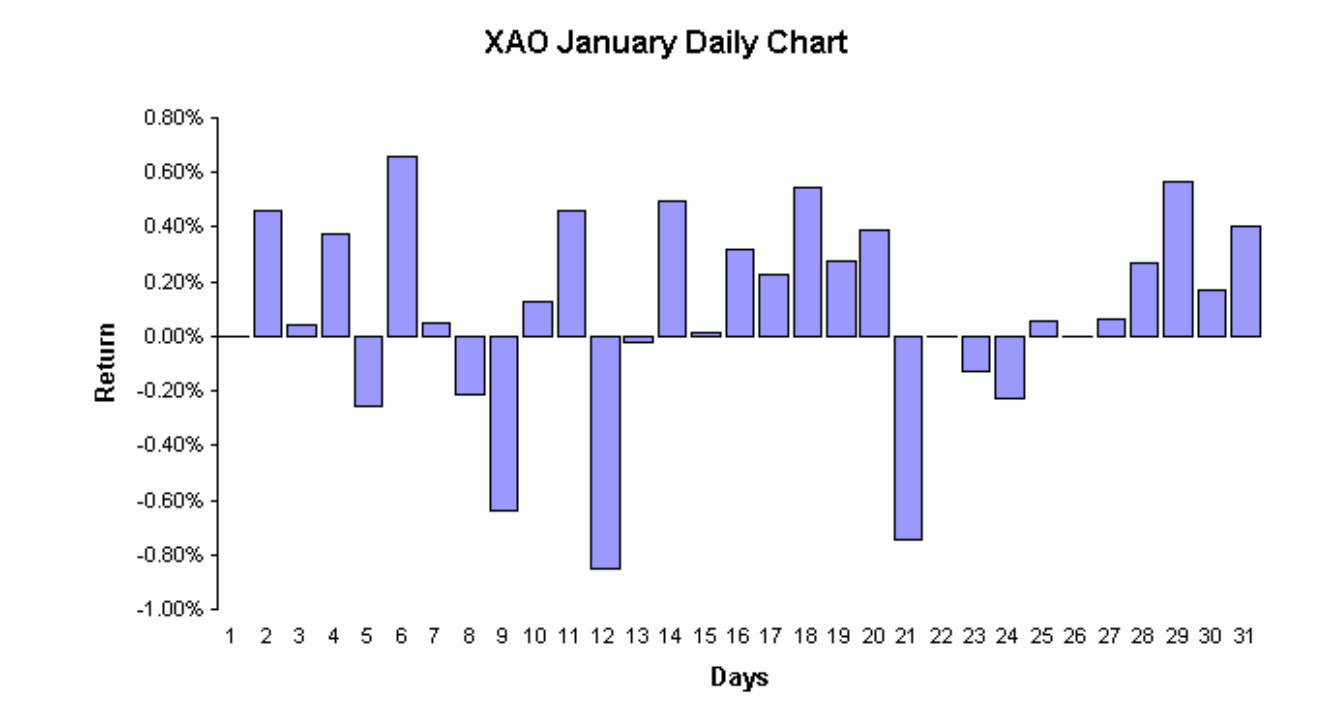
The surprising result is when January is a down month. When this happens there is a 100% probability that February will be an up-month. This provides buying opportunities on weakness in January. Some traders use this as an opportunity to add to existing positions if January turns out to be a down month. Other traders use a January down month as a signal for aggressive buying going into the February rally. January is a down month 27% of the time.

By considering how the month has performed over the past 11 years, traders can develop several trading strategies. The first group of strategies are entry and exit strategies based on the performance of the month.



The average gain made during January is 2.88% which is a significant gain over the average increase for December of 0.75%. The poor average December figures hide some very useful gains in individual stocks. Statisticians will draw many other relationships for 11 years of market performance but we are interested in broad relationships. It is inappropriate to use these relationships as a predictive tool, but they are useful in providing a broad

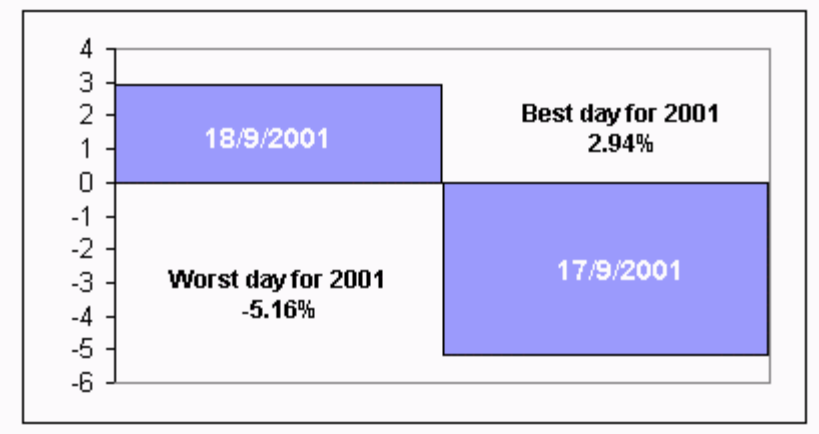
background to market behavior which assist traders in deciding what weight they should give to bullish or bearish behavior during the month.



The final group of trading tactics using these types of statistical relationships are based on the average performance of individual days of the month over a 6 year period. This is not to say that the performance for each day will be repeated, but it helps to establish the average range of market activity.

The analysis of the results for each date in January shows:

- Highest average return of 0.66 for a day is on January 6.
- The lowest average return of –0.85 is on January 21.
- There is also a 74% probability that on any day of January, the market will show a loss or sideways movement for the day.



When we use these statistics on a day by day basis, we must be cautious. These show the performance of the XAO as an index and the level of volatility is dampened because of the way the index is weighted towards larger stocks. In 2001 the best return – open to high - on any day for the year was on September 18 with a 2.94% This was also the best one day gain for 2001 as the open was also the low for the day.

. The largest one day loss – open to low - was on September 17 when the US market re-opened after the September 11 terrorist attacks. This was a 5.16% loss and was also the largest one day loss for the year. The high of the day was also the open. The largest swing day ranges for the year are on down days. The third largest is the bullish day on September 17.

These extremes are dampened when we consider the average return for individual dates in the month. When we consider index performance we may need to factor this upwards to get a better indication of the way individual stocks may perform. A highest average return of 0.8% for a day on

March hides significantly better one day returns available from individual blue chip, madcap and speculative stocks.

On the broad scale of general performance for the month, and in the relationships between months, the statistics are useful in establishing broad trading strategies. When we look at the relationships on a date of the month basis, the relationships are much more volatile. Any selected date on 2002 may perform much better, or worse, than the same date, on average, over the past 6 years. It is unwise to rely on a repeat performance of any given day. However, there are clusters of days where there is a high level of agreement between the historical and current performance. We examine these relationships every month.

READERS QUESTIONS - CONSTRUCTING THE GUPPY MMA OSCILLATOR

By L Wilson

INDICATOR REVISION

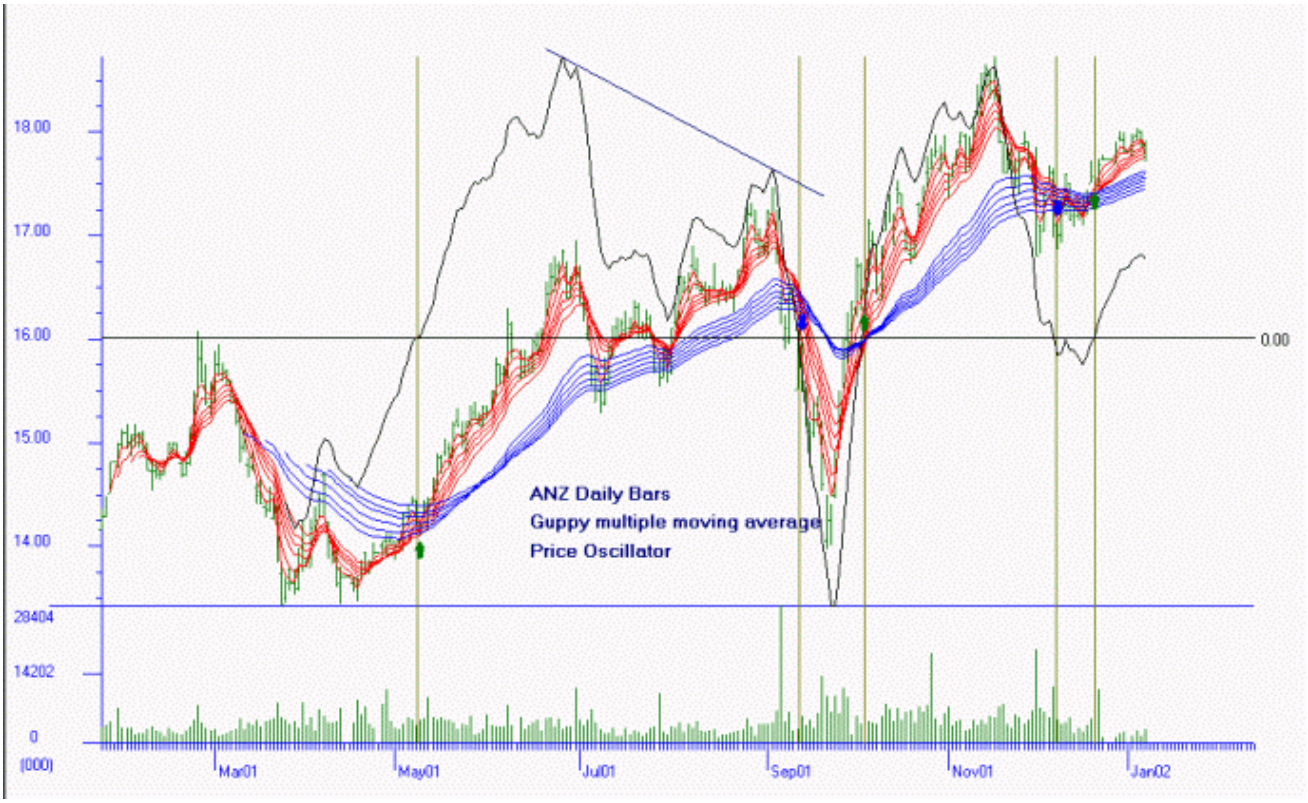
OSCILLATORS

Indicators based on oscillators are plotting cyclic activity. This is where a relationship moves between and upper and lower boundary. This boundary is often decided on the basis of a relationship with a previous point. If the boundary is exceeded then we know a new trend has been established. More commonly, the boundary signals a turning point as prices tend back towards the centre point between the boundaries. Oscillators are used to identify turning points by measuring the speed and momentum of the surges of crowd activity. Oscillators assume there is a boundary, and this is not always

There have been some queries regarding the construction of the Guppy MMA Oscillator for both Metastock and Ezychart. We will start with Ezychart first.

Ezychart users do not have the capacity to write formulas as they do with Metastock, so we will have to compromise to some degree. We do this by using the price oscillator and entering the median moving average values. For those of you new to Ezychart or not familiar with indicator alterations, first click on “indicator” at the top of your screen then scroll down and click on “preferences” at the bottom of the menu. You will now have a split table in front of you. Click on “Price Oscillator” in the “Indicator Setting” section and this will bring the price oscillator window to the front. You will notice references to short and long term moving averages.

For the short term moving average, enter 9 and insert 45 in the long term moving average section. On the left of your window you have “Tool Bar Selection”. Tick the price oscillator box



and this will place the indicator button on your main screen. Now tick the "Set as Default" box and then click finish. You must tick "Set as Default" otherwise the previous settings will remain as the oscillator parameters.

Ezychart users must remember that the price oscillator operates on the calculations of two moving averages where the Guppy multiple moving average consists of twelve, so there will be subtle differences between Metastock and Ezychart displays. In addition we do not have the capacity to add a trigger line if required in order to replicate the MACD but this should not necessarily be seen as a disadvantage. We still receive all the benefits of divergence signals and all zero line cross overs are reflective of crossovers of the Guppy multiple moving average. A bonus for EzyChart users is now we have the option to perform searches for crossovers of the Guppy multiple moving average using the above price oscillator parameters. Just run your analyzer as normal and select price oscillator cross over at step two. Now providing you ticked "Set as Default" as instructed earlier all selected stocks will have experienced a Guppy MMA crossover within the specified period.

For Metastock users, the process is a little more involved. First open your indicator builder and click on "New". Now enter the following formula:-

Name:- Guppy MMA Oscillator

Formula:-
((Mov(CLOSE,3,E)+Mov(CLOSE,5,E)+
Mov(CLOSE,8,E)+Mov(CLOSE,10,E)+
Mov(CLOSE,12,E)+Mov(CLOSE,15,E))-
(Mov(CLOSE,30,E)+Mov(CLOSE,35,E)+
Mov(CLOSE,40,E)+Mov(CLOSE,45,E)+
Mov(CLOSE,50,E)+Mov(CLOSE,60,E)))*10;

(Mov((Mov(CLOSE,3,E)+Mov(CLOSE,5,E)+

```
Mov(CLOSE,8,E)+Mov(CLOSE,10,E)+
Mov(CLOSE,12,E)+Mov(CLOSE,15,E))-
(Mov(CLOSE,30,E)+Mov(CLOSE,35,E)+
Mov(CLOSE,40,E)+Mov(CLOSE,45,E)+
Mov(CLOSE,50,E)+Mov(CLOSE,60,E)),13,E))*10;0;
```

For readers interested in price oscillator configuration and not requiring the trigger line, only enter the first half of the formula. I multiply my values by a factor of ten. This gives a full number indicator value on screen which I find much easier to interpret than all those zeros. The multiplication factor is not essential to the operation of the indicator, so you may delete it if you wish. Now that you have entered the formula, make sure the "Show in Quick list" box is ticked and click "OK". There all done.

CHART BRIEFS –IRE

By P Rak

TRADING TECHNIQUES

CBL STOP LOSS

This stop loss rule uses the range activity of the stock to set a stop loss point. The range is the distance between the high and the low for the day. It is calculated using the Count back Line approach. Taking the most recent highest high in the intermediate term trend the stop loss point is calculated by counting back three lower bars. The horizontal line drawn at the bottom of the third bar is the stop loss point. This stop loss is not related to the 2% rule. The line suggests the conditions where the trend may be weakening. When used with open profits, it provides an exit signal to protect those profits.

The daily price bar chart shows a relatively new stock, IRE, which commenced trading in late October 2001. The stock has an average daily trading volume of 153 000, and since trading commenced has been moving sideways, with most price activity between $2.10 and $2.20. There is no indication of trending behaviour.

Analysis of new stocks for trading opportunities is difficult, due to the absence of much historical price data and therefore the indicators and patterns that derive from it, such as moving averages and well defined straight edge trend lines. One of the first common indicators able to be used are Bollinger bands, which require around 6 weeks of price history. The Guppy MMA and Price Oscillator require at least three months of trading history.

This means we need to place a greater focus on the tools of risk management and blue sky trading to determine whether a newly floated stock that crosses our screen is an opportunity. Risk management tools that assume primary importance in new stocks are CBL stop loss and profit protection levels. Tools of blue sky trading include blue sky target setting (see below), supported by straight edge trendlines and basic chart patterns where available. Darvas boxes are also a useful tool in trading new or blue sky stocks.

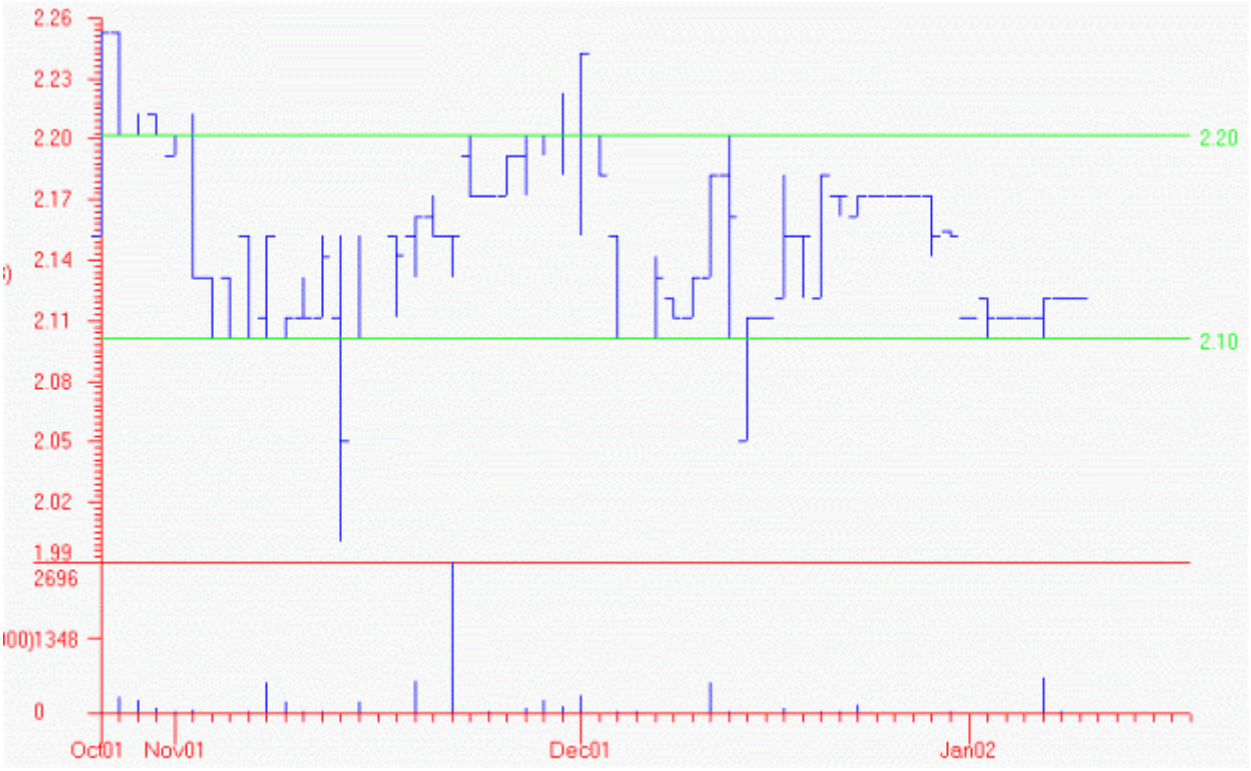
UP CONDITIONS

The dominant feature on the daily price bar chart is the development of a consolidation band. The distance between support level and resistance level is $0.10, therefore 4.76%, which means that IRE is not a candidate for channel trading.

A sustained breakout above the $2.20 resistance would increase upside probability. An initial price target can be set by projecting the width of the prior consolidation band ($0.10) upward from the top boundary of the band to give an initial target of $2.30 ($2.20 plus $0.10). Tools such as a straight edge trend line or Darvas boxes can be applied to the breakout.

DOWN CONDITIONS

A fall through the support around $2.10 will increase the probability of downward movement. Downside price targets are set in a similar way as upside targets above, hence around $2.00, which corresponds to the low in IRE. The lack of developed support levels in new stocks increases the importance of risk management methods such as CBL stop losses.



NEWSLETTER OUTLOOK –TREND REDEVELOPMENT

We remain in a cautiously bullish outlook as the market moves beyond the Christmas trading period. The index behavior confirms this is part of a general November and December rise that often continues strongly into January. Our preference remains towards the management of longer term trend trades rather than maximizing short term profits.

Each week we make a choice about the material we include and the subjects we cover. The selection is based on our outlook for the current and coming market. Our objective is to illustrate effective trading strategies that readers can apply to current market conditions. We do not identify recommended individual stocks. We identify opportunities and appropriate trading methods for them. Our outlook is not a forecast. It is a probability framework. Use it as just one part of the other information you are reading about the market. Our summary outlook will be included each week.

NEWSLETTER NOTICES

EXPERIENCE HURTS

In the newsletter prior to Christmas we noted the way the market has a habit of developing unexpected bursts of activity between Christmas and New Year. One strategy to take advantage of this is to place sell orders well out of market. These take advantage of these Christmas spikes. It is a strategy we use.

Unfortunately, experience and newsletter notes are no antidote to stupidity. In November due to the shutdown of the Noalls online trading site, we transferred our business to AOT On Line to take advantage of stop loss conditions and other electronic services. This meant that our old good until cancelled sell orders had to be re-entered. It seems we missed one in the transfer.

However, believing that we hade reinstated all GTC orders, we foolishly did not check this when we added new GTC sell orders for the Christmas period.

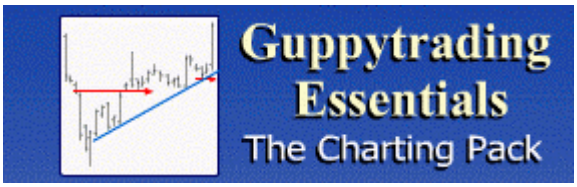
The result? You guessed it. The one stock we overlooked took a gallop between Christmas and New Year, hitting our targets and taking out our sell order – except our order was not there! We missed a 60% profit and it is entirely our responsibility.

The gallop has turned to a stumble, with prices collapsed back to a pitiful 5% profit. This trade now calls for new management techniques. This is one mistake we will not make again.

GUPPY CHARTING SOFTWARE

Over the past few months we have been working with Market Analyst to develop a Guppy Trading Essentials charting package. This is built on the Market Analyst platform and includes basic charting essentials and a specialist Guppy toolkit. We had hoped that the software would be fully completed by December. However, there is still some fine tuning required and we will not release this product until we are satisfied it is running smoothly.

This charting package is open platform and can read Metastock, Assci, txt,, Freeway and other data formats.



The package is developed by Market Analyst and uses indicators developed by Daryl Guppy and Alan Hull. The charting package is distributed by Dane Boag Pty Ltd via a new web site which is licensed to use the Guppytraders name. Full details of the package, including a fully working demo copy will be available from www.guppytraders-essentials.com

This is charting software that grows with your trading skill.

- This charting tool box includes all the standard charting tools you would expect, from Relative Strength Index and MACD to Moving Averages and Linear Regression.
- Display options include bar, candlestick, Kagi, several point and figure choices and line charts.
- This pak includes a specialist tool kit developed from **Share Trading** and **Trading Tactics** by Daryl Guppy. These are automatic count back lines, stop loss lines, the Guppy Multiple Moving Average, automatic Darvas boxes, chart inversion and more. This pak includes the Range Indicator and Rate of Return indicators from **Active Investing** by Alan Hull.
- An essential analytics tool kit is included.
- Compatible with most data formats.
- This charting tool box is compatible with other tool kit modules from Market Analyst Software, including Gann and Fibonacci. These can be added at any time to build a charting tool box to suit your trading needs.
- Other toolkits will be available, including candlesticks, day traders Tony Oz and others for the real time version, advanced point and figure, etc.

We have not been involved with the development of Ezy Charts since mid 2001, and like many users, we have concerns about data choices and service support. Our involvement with Market Analyst has been designed to overcome these issues which we believe are important for all traders.

In future issues of the newsletter readers will see the same coverage of Metastock, Ezy Charts, Supercharts, and the new GTE pak. We will continue to recommend the most appropriate software for clients based on the skill level, experience and needs of each individual client.

MISSED ISSUES OVER CHRISTMAS

Some readers will choose not to take their laptops with them on their holidays and will miss downloading some of the January issues. You can download the newsletter from any computer simply by typing in your password. The password does not depend on the computer you are using. If you miss an issue at any time, just drop us a note at support@guppytraders.com listing the issues you missed and we will email them to you.

NEWSLETTER SAMPLE TUTORIAL PORTFOLIOS

TUTORIAL PORTFOLIO 1 - MONEY MANAGEMENT

Starting cash position $100,000 - no brokerage or slippage 2% of risk = $2,000

Stock	Price	Qty	Pur Value	Close	Cur Val
RGS	$1.060	19,000	$ 20,140	$ 1.2900	$ 24,510
		Entered	12-Nov	Open Profit	4,370.00
Trend lines and time deadlines				Percentage	21.70

Stock	Price	Qty	Pur Value	Close	Cur Val
IDX	$2.700	7,500	$ 20,250	$ 2.7900	$ 20,925
		Entered	12-Nov	Open Profit	675.00
CBL stop loss				Percentage	3.33

SUMMARY MONEY MANAGEMENT

Overall profit to date since July 1, 2001 = $54,205 or 54.2% return on trade equity.

Profit 2000/01 = 59.2% return on trade equity.Profit 99/00 = 111.2% return on trade equity

Profit 98/99 = 102% return on trade equity. Profit 97/98 = 94% return on trade equity.

Profit 96/97 = 66.5% return on trade equity.