

The 50-50 Strategy

by Dr. Charles B. Schaap
Use moving averages to follow the trend.

The moving average is one of the most basic concepts in stock analysis. Moving averages provide an excellent visual reference for judging the strength and direction of a stock's trend. Your investment time frame and corresponding moving average can even provide the foundation for a simple, effective trend-trading system -- one I call the *50-50*.

THE THREE TRENDS

There are three types of trends that play out simultaneously in the market, and a good trading strategy takes them all into account. The long-term trend establishes a bull or bear market and lasts months or years; this is the trend that investors focus on. An intermediate-term trend lasts weeks or months, and is responsible for market corrections and the upward legs of the long-term trend. Short-term trends are corrections of the intermediate trend.

The 40-week moving average is a good reference for long-term investing. A 40-week moving average on a weekly chart is represented by a 200-day moving average on a daily chart (five trading days per week multiplied by 40 = 200). Stocks with prices above the 200-day MA are considered bullish and represent buy candidates. Stocks below it are considered bearish and best avoided, unless you are considering a sell strategy. For this article, I will assume a bullish bias.

The 50-day moving average best represents the intermediate-term trend. Most investors and traders will find the 50-day MA an excellent point to enter or exit trades. By using both the 50- and 200-day moving averages together on a daily chart, we are able to quickly judge the intermediate and long-term trends of a stock under consideration.



STRONG UPTRENDS

During a strong uptrend, prices will generally remain above the 50-day MA, but periodically make countertrend corrections. The first pullback from a breakout in a new trend often touches the 50-day MA. Two or more closes above the 50-day MA on the pullback indicate strength. These pullbacks are excellent times for entering a new stock position or adding to an already established position.

Every stock has its own personality, but once a trend is established, it is common for stocks to drop for three to five days and touch the moving average, then resume the uptrend. Less frequently, the stock will drop five to 10 days to the 50-day MA. These pullbacks are additional entry points. A good sign of a healthy pullback is low down-volume relative to the up-volume that preceded the decline.

The challenge on pullbacks is timing the entry. Anytime you add an oscillator to short-term trend reversals, the entries will be more precise. J. Welles Wilder's relative strength index (RSI) is my favorite oscillator to use on trending stocks, because RSI has both oscillator and trend-following characteristics. RSI is versatile; it can be used to indicate overbought/oversold conditions and to expose bullish/bearish price divergences. In addition, you can draw trendlines on the RSI and monitor them for violation.

The 14-day RSI works well for timing the end of short-term reversals. Overbought signals in an uptrend are unreliable, but oversold signals usually work well. Look for trend reversal signals when the 14-day RSI is less than 30.

The 21-day RSI also has trend-following characteristics. Rather than using overbought/oversold levels for signals, trend strength is indicated when the 21-day RSI is above 50 (bullish) or below 50 (bearish). A cross from below 50 to above 50 is a buy signal, and a cross from above 50 to below 50 is a sell signal. Thus, the 50-50 system uses a 50-day MA and the 50 level of the RSI to generate signals.



Figure 1 shows that in late April, Hot Topic, Inc. (HOTT), broke out of a consolidation. It pulled back to the 50-day MA in late May. Note that both the 50- and 200-day MA slope upward and the distance between the moving averages is widening. This is a sign that the stock is gaining upward momentum. In late June and early August, there were two more opportunities to enter the trade.

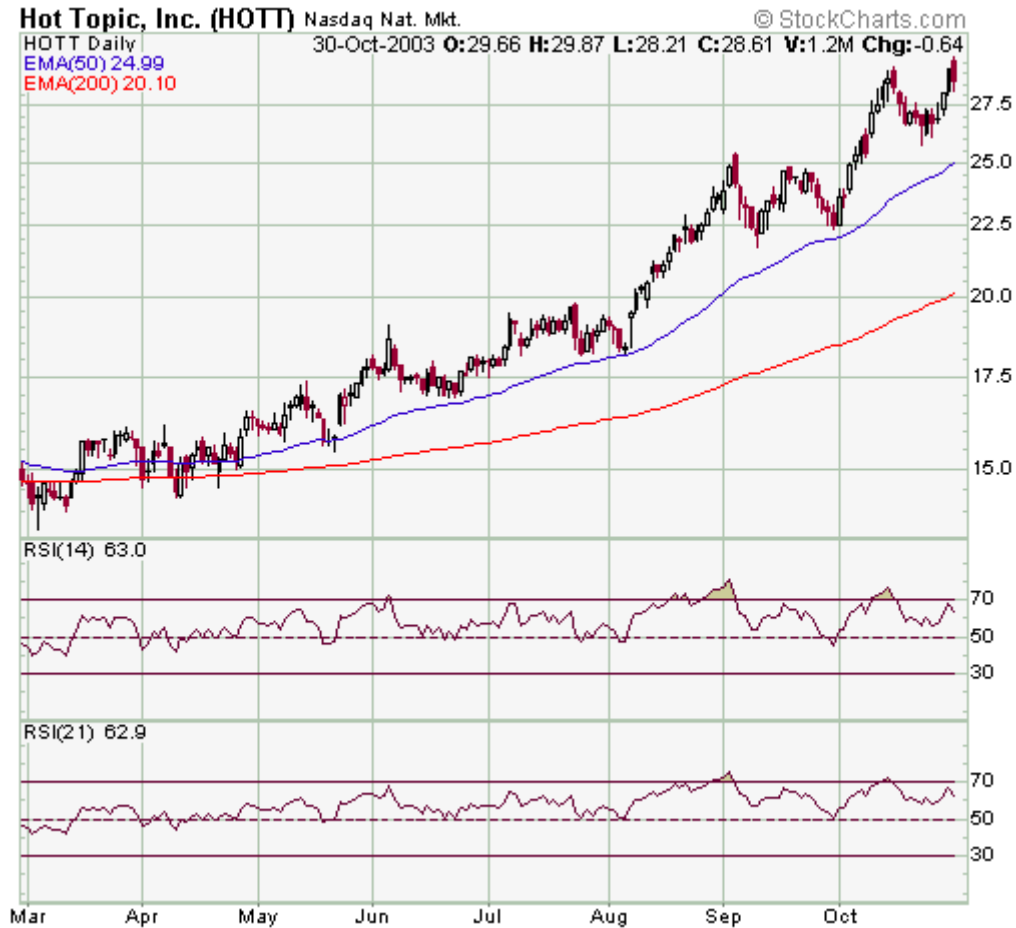


Figure 1: The 50-period MA and 200-period MA. The widening of the distance between these two moving averages suggests that the uptrend is still strong.



At the beginning of October, still another chance to enter appeared when momentum increased, as evidenced by the increased angle of the 50-day MA. Although price pulled back to the 50-day MA several times, the 21-day RSI did not drop below 50, so the bullish buy signal was present throughout the ascent of the stock. The 14-day RSI gave good short-term reversal signals.

The major challenge with the 50-50 strategy is to avoid the temptation to buy a stock that is far above its 50 MA. Often when you see all those big white candles, you start thinking that you are going to miss out on all the action. Well, sometimes you *do* miss out. This strategy is most appropriate for the investor who favors safety and reliability over the possibility of high-flying profits. Remember that stocks always return to their moving averages eventually.

Though you may assume you should enter a stock on any breakout, keep in mind that entering a position when price is far above its moving average is risky. Often, a stock is purchased on a big breakout, but the stock then falls back to one of its moving averages — below the entry price. If you had waited a few weeks, you might have been able to buy that stock for the same low price — or even a lower price. The point is that good trends are long-term events, so wait for a good, profitable entry near the 50-day MA.

Figure 2, a chart of Network Appliance (NTAP), illustrates this point. A breakaway gap appears in mid- to late August. But the price was \$22.49, high off of the 50-day MA. The 14-day RSI is significantly overbought on the breakout, leaving little room to go. If you had waited for the pullback that took place in late September, you could have purchased NTAP for \$21.05, \$1.44 cheaper, and you would have saved several weeks in a losing trade, or avoided being stopped out. On the pullback to the 50-day MA in September, the 14-period RSI was oversold, and the 21-day RSI dipped slightly below the 50 level.



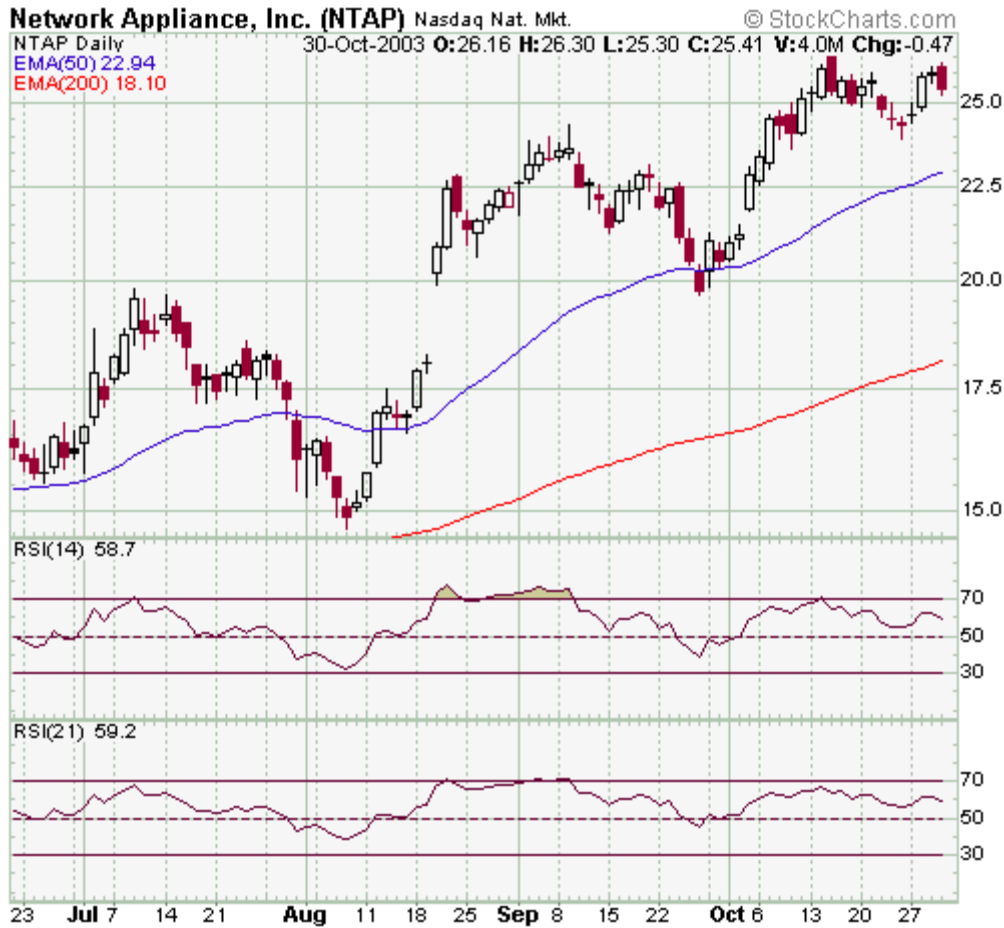


Figure 2: Using moving averages with the relative strength index. Sometimes purchasing a stock that is too high above the moving averages can be risky. Using them in combination with the RSI can help confirm your buy signal.

THE STRATEGY

The power of the 50-50 strategy is its simplicity, and it is something a beginner or advanced trader can use. If you buy an upward-trending stock at the 50-day MA when the RSI is above 50, and sell at the MA some time later, it is highly probable you may benefit from a profitable trade (assuming you follow good entry/exit techniques). Trying to follow too many indicators often leads to confusion and the inability to act decisively when a buying opportunity presents itself.



The 50-50 Strategy

Buy when:

- Stock is uptrending and pulls back to the 50-day MA
- RSI 14 is oversold and reverses
- RSI 21 is above 50
- Price reverses upward (see below)
- Initial stop-loss is .25 below the low of the reversal

Exit at the first close below the 50-day MA.

This strategy lends itself well to tweaking with your favorite methods, but the framework is there for a solid trading system. A couple of additional rules are helpful in trading this strategy:

Always look at multiple time frames when trading trends, no matter what time frame you use to enter and exit. When multiple time frames align in one direction, there is greater momentum pushing the stock toward higher prices. Find a stock in both monthly and weekly uptrends, then wait for the daily price bars to start a new daily uptrend with prices near the 50-day MA. Look at the monthly, weekly, and daily time frames, and wait patiently for them to align. This increases the probability of a profitable trade. Remember, sometimes the best trading signal is the signal to do nothing with a particular stock or at a particular time.

Always exit on the moving average you entered with until a longer-term moving average reaches your entry price. If you enter on the 50-day MA, then you should exit on the 50-day MA. If I decided to be more aggressive and enter on a shorter-term moving average such as the 20-day MA, I would exit on a close below the 20-day MA until the 50-day MA reaches my entry price. Then I could use the 50-day MA for an exit signal at a later date. Keep your time frames straight. Don't enter on the 20-day MA and let price fall to the 50-day MA, or you might end up with a losing trade.

The best buy signals occur when both the 14- and 21-day RSI are oversold. For the 21-day RSI, that may mean a short dip under the 50 level; for the 14-day RSI, it means a cross below 30.



A good signal occurs when the 14-day RSI is in a downtrend, crosses below 30, and then either fails to make a lower low (double bottom) or makes a higher low while price makes a new low (bullish divergence). I like to draw trendlines on the RSI and buy when price breaks the down trendline. When the slope is too steep to draw a good trendline, use horizontal resistance instead.

Always wait for price to confirm the reversal. A price reversal is a three-bar formation composed of a middle price bar (or candle) with bars on either side having lower lows. When you see such a reversal along with your other signals, plan to buy when the next day's price rises above the high of the middle bar.

MONEY MANAGEMENT

There will be times when the stock drops below the 50-day MA on a correction. Exit at the first close below the MA, even if you suspect that the stock may come back quickly. You don't want to own the stock once it is under the 50-day MA, because you want to book profits on the trade. If the stock later reverses and closes above the 50-day MA, and the RSI indicates a reversal, then you can buy the stock again to ride the next wave. Since most online commissions are under \$10, this strategy is feasible in the long run. Remember to be disciplined.

One of the best benefits of the 50-period MA technique is that it helps you to place a great stop-loss. If you buy a stock that is far above the 50-day MA, where do you put your stop-loss? A wide stop-loss will increase your losses if you get stopped out. A good entry is calculated not just for maximum profits, but also for minimum losses. Once your profit is 10% above your entry, the 50-day MA is your stop-loss from there on out. There's no need to keep calculating new stop-losses, since most charting software gives you numerical values for the moving averages. Be sure to choose a stock with good fundamentals, so the trend will have long-term potential.

The 50-50 strategy uses the 50-day MA and the 50 level of the 21-day RSI as signals for entry on trending stocks. It uses trend-following indicators to measure the trend, and oscillators for timing entry on pullbacks. The system is reliable, easy to implement, and allows for a good stop-loss.



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