G&T TRADER

Beginner's Guide to Stocks

Chapters 1.1 - 1.6

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Stocks
Chapter 1.1 / Introduction

Introduction

Welcome to this Academy introduction to stocks investing. In this course, we will focus on what stocks are, main benefits of investing in stocks and strategies for investing in the stock market.

Long before the New York Stock Exchange (NYSE) introduced securities trading in 1792, the Italian city-states, led by Venice, pioneered the exchange of securities in 13th century. Following the steps of the Venetian merchants, other European businessmen looked to fund explorations and trading ventures through the issuance of shares. In 1602, the Dutch East India Company issued the first paper shares of a company. Investors were not only able to pool their money together and become shareholders of the company, but they were able to freely exchange the shares among them. Soon, other companies followed the example and the first brokers of shares started to appear. In London, brokers would gather in a coffeehouse to trade stocks. That coffeehouse would later change its name to London Stock Exchange (LSE) in the year 1773.

Today, the world's largest stock exchanges can be found around the globe from New York to Bombay. New York Stock Exchange is considered the largest by value and volume, followed by Nasdaq, Tokyo and London Stock exchange.

Why do companies list their shares on stock exchanges?

In attempts to grow and transform their businesses further, private companies will look to raise capital by offering their shares to the public. By doing so, the owners of the company will give up some of their ownership in exchange for the capital they need to expand. The process of listing shares is known as "underwriting" and large investment banks such as Credit Suisse and Goldman Sachs typically administer it.

After shares of a company are issued at the "primary market" or at the initial public offering (IPO), they start to trade on an exchange. The pool of shares available to buy and sell at the open market is then known as the 'float.' For example, the Chinese online retailer, Alibaba, recently listed its for what became the largest IPO in history. The company raised capital in excess of $20 billion, as a result.

Key Terminology

Share

When you buy shares of a company, you become an owner in the company and thus you are entitled to the earnings generated from the company's business. You become a shareowner. Stocks are also referred to as equities or securities.

One of the most famous stock investors of all time, Benjamin Graham, defines stock as an ownership of an actual business with underlying assets with value that does not depend on its share price.

Shares outstanding

The total number of shares issued by a company is defined as shares outstanding. Authorized shares describe the total number of shares a company is authorized to issue. This takes place when the business is first incorporated. For instance, if company's articles of incorporation show that XYZ has authorized one million shares, then only one million shares can be issued and not more.

From the authorized shares, company XYZ may offer 300,000 shares through an IPO to the public. The company, in the form of treasury stock, retains the remaining shares of 700,000. At a later stage, the company may offer more shares or decrease the number of shares in the market in the form of 'buyback.' Buyback can occur when companies have extra cash on hand and are looking to 'retire' or cut down the supply of stocks in the market place. By cutting the supply, the value of the shares may increase further.

Market capitalization

The term refers to the market value of a business measured by its price per share multiplied by the shares outstanding. In the example below, the market capitalization for the U.S. Company Microsoft is shown at $394 billion.

Microsoft (MSFT:xnas)	United States
Last close (USD)	47.66
Avg. consensus rating	BUY
No. of Analysts	36
Avg. consensus target (USD)	49.91
Implied price (USD)	33.29
Beta	0.99
Market cap. (USDm)	392,854
Industry	Packaged Software

With capitalization of $394 billion, Microsoft will be referred to as a large capitalization company, or just ‘large-cap’. By definition, if a company has a market value above $10 billion, it’s considered large-cap. If between $2 billion and $10 billion, that capitalization is considered ‘mid-cap’ and below $2 billion- ‘small cap.’

Investment vs. speculation

There is a fine line between what constitutes investing and speculating, but it is important for stock investors to come in grips with the two as it may help them define their approach to the stock market.

Investment may take many forms; you may invest in land, commodity like gold or in a company as in the case of stocks. As an investor you mays look at the value of the underlying business of the company and compare to its current market price on the exchange. As a result, you may hold this investment from several months to several years.

As a speculator, however, you may not take time to know the business that intimately. You would look to benefit from the fluctuations of the stock prices and buy shares in order to sell them at a higher price to someone else. As a time horizon, you may hold these shares from a few days to a few weeks.

Again, it is difficult to distinguish the two terms without being subjective. Most individuals would speculate in the market place simply because we don’t have the time to investigate in details the businesses, assign a ‘fair’ value to these and ‘stick’ with these investments for a long time.

Risk

In finance, the possibility of losing an investment principal is referred to as risk. The more risk you will take in the market, the bigger the potential for loss or gain. Sometimes, risk is referred to as volatility or how much an investment can fluctuate up or down. It is imperative for novice and experienced investors, for that matter, to understand the implied risks of a stock investment.

There are other risks involved with investing in the stock market is systematic and unsystematic risk. The systematic risk is non-diversifiable risk as it is simply the risk of being in the market. No matter how diversified your portfolio was during the 2008 financial meltdown, it was probably hit by the falling market prices. Unsystematic risk, on the other side, is risk, which you can diversify against. This is the risk you would take with one particular stock investment, which you can offset with another, unrelated stock position.

Take time to research the companies you are considering and assume worst-case scenario. Warren Buffet, one of the most successful investor, once said that risk comes from not knowing what you are doing.

Summary

Throughout the century exchanges around the world have become an important mechanism for companies to raise capital. Shares, with trillions of dollars are bought and sold on the secondary markets through exchanges like NYSE, LSE and Nasdaq. Whether you are looking to speculate on the stock market or you are looking for the next Apple shares, or both, you must take time to learn understand the risk in the market and manage it. Only by minimizing the risk and the potential losses that could come with it, you would be able to hold onto your gains and move forward.

Stocks
Chapter 1.2 / Types of Stocks

Stocks can be classified according to various characteristics such as type, location, sector and size.

Type

Publically traded company will offer two kinds of stocks - common and preferred. A common stock is typically what most businesses will issue. As mentioned in section one, common stock represents an equity ownership in a company. Owners of common shares may or may not receive dividends from holding the equity. Shares of British American Tobacco, in the example below, pay annual dividend yield of 4.13%. Most common shareholders, however, would prefer the price appreciation than the income from dividends.

British American Tobacco (BATS:xlon...

Instrument: BATS:xlon
British American Tobacco

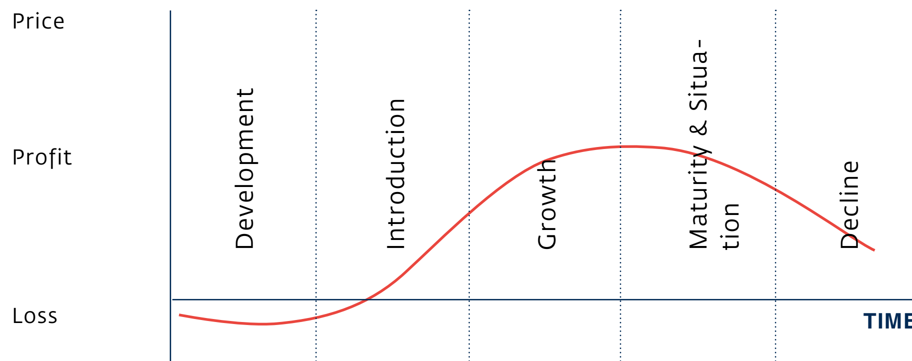
Fundamentals (GBp)

Average target	3,649.43	Last close	3,515.50
P/E (2014E)	17.33x	52w high	3,794.50
P/B (2014E)	9.65x	52w low	2,881.00
Div. yield (2014E)	4.13%	Tobacco	

Preferred shares will almost always distribute dividends to shareholders. Due to its "preferred" status, the payment of dividends will occur before any payments made to common stockholders.

Size

In section one, we mentioned that according to their market capitalization stocks are divided in three different categories: large-cap, mid-cap and small-cap. Large capitalization companies, such as Daimler AG or General Electric, are more established and tend to have more stable earnings. Stable earnings can often translate to stability in the share price. On the contrary, small capitalization companies tend to have unstable earnings and share prices. Investors could find a compromise with mid-cap stocks, which offer growth and stability of a larger company.
The graph below illustrates the growth cycle of companies. During the "infancy" period small-caps may experience modest growth illustrated by the slight upward slope of the "S" curve. During the "expansion" businesses will have accelerated growth before reaching "maturity" where they will show little or no growth.



Domestic vs. Foreign Stocks

By location stocks are simply defined as domestic and international. Wayne Gretzky, a famous hockey player once said: ' I skate where the puck is going to be and not where it has been'. Perhaps this is why investors would need to be mindful of both domestic and global opportunities for investing.

According to the World Trade Organization, over 50 per cent of developing markets merchandise was sent to developed countries in 2014. China has become the world's largest exporter of merchandise, recording a trade surplus of $259 billion or 2.8% of its GDP. While we certainly don't want to "bet the farm" on Chinese stocks, we could consider allocating a portion of our investable assets towards international stocks.

Over the last decade, some investors have approached index-based investing or instruments called Exchange Traded Funds (ETFs) to gain exposure of foreign markets. Others, with direct access to global stock exchanges have been able to invest directly.

What are the advantages and disadvantages of investing in foreign stocks?

One of the main benefits to investing in foreign stocks is diversification. Most of investors my have near-site vision when it comes to investing and invest in we know best – our own market. This bias towards domestic companies has its benefits but it also has its risks. For instance, if you invested your entire portfolio in Greek stocks over the last decade, you probably got “crushed” by the economic meltdown in that country. According to MSCI Greece Index, since 2008 Greek stocks are still down 51% on average. In contrast, world markets are on average 35% for the same period.

Foreign stocks, particularly in emerging markets as these economies are in the midst of rapid economic growth, could also reward investors looking for higher growth. The comparison chart below could support this argument, at least in numbers. While shares of American tech giant Google have returned an outstanding 103%, shares of its Chinese counterpart Baidu, have gained formidable 460% on average during the last five years. One must mention here that potentially higher returns could lead to higher investment risks.

One of the biggest disadvantages of investing in foreign stocks could be the risk of foreign exchange. Foreign companies trade and pay dividends in their own currencies.

For instance, if you were a German investor and you owned shares of U.S. Company Wells Fargo, you would receive dividends as shareholder. If you held 500 shares of Wells Fargo and the company paid out quarterly dividend of $.20 per share, you would receive $100. That amount, however, could be subject to tax withholding and would have to be converted in euros – the currency of your brokerage account.

Aside from the potential tax and exchange rate conversion fee on the distributed amount, you might be at a disadvantage simply from a weaker U.S dollar. Suppose the dividend income of $100 converts into 82 euros. If the dollar rises relative to the euro, it would be benefit you since you would receive more euros. However, if the dollar weakened and instead of 82 euros you received 75 euros, your total investment return would diminish.

Other potential risks that you could experience with foreign stocks could come as a result of geopolitical events. Egyptian equities outperformed their emerging market benchmark consistently over five and ten year time frame. Nevertheless, in the last three years the country has suffered political instability, which has impacted its economic production.

Last but not least, smaller markets around the world trade significantly less volume than some of the bigger exchanges. This may lead to lack of liquidity where investors might be at risk of not being able to easily sell their stock holdings.

Summary

Corporations will generally issue common and preferred shares. Preferred shares have advantage over common shares, as their shareholders will receive any paid out dividends before the common shareholders. Investors looking for total return could consider stocks that pay out dividends and also provide growth.

The market capitalization of a company is determined by the number shares outstanding multiplied by it's price per share. Large-caps are stocks of companies in "mature" stage with stable or limited growth potential. These companies tend to grow from acquisitions of other companies.

Investing in foreign stocks can potentially require higher tolerance for risk but could reward investors by providing diversification away from domestic assets.

Stocks
Chapter 1.3 / Corporate Actions

A corporate action is an event, which will influence the stock shares of a company in different ways. Some examples of a corporate action are stock splits, dividend distributions, buybacks, mergers and acquisitions, rights issue and others. The company's board of directors typically initiates the process. In the following section, we will define each of these actions and provide an opinion on the potential impact to shareholders.

Stock splits

As the name implies, when such action takes place a company will split its outstanding shares according to a certain ratio, i.e. 2 for 1, 3 for 2 and so on. The two types of stock splits are forward and backward or reverse split.

Recently, shares of Apple went through a forward split of 7 for 1, shareholders received 7 additional shares for every 1 share they owned. Upon the stock split, the share price is also adjusted. If shares of Apple traded at $630 just before the split of 9th June, after the split the opening share price adjusted according to the ratio of 7:1,or $92.83.

The weeks following the split, Apple's stock rallied 17%. Although we cannot expect such bullish sentiment from every forward split, investors who have a little more appetite for speculation can carefully consider buying into a stock split.

Some experts argue that the benefit of stocks splits to investors is almost zero. Micheal Sheimo in his book Stock Market Rules argues that the affect is only psychological and conveys just a warm feeling. One on side, we could site with this argument if we looked at the investment from a different angle. Our total capital investment would not increase, just the amount of shares. It's like having a one 20-euro note in your wallet versus holding two 10-euro notes. The value of 20 euros stays the same in each case. It maybe worth noting here, that the class A shares of Berkshire Hathaway have never split despite of the astronomical price tag per share of $226,500.

In a reverse stock split, instead of increasing the number of shares and decrease the share price accordingly, the event will decrease the number of shares and increase the price per share according to a ratio. For instance, a management can vote for a reverse split, when the value of the underlying shares has moved too low. Suppose that level is $5. Certain institutions, such as mutual funds, may avoid lower-priced stocks as part of their offering memorandum.

To illustrate the above, let's walk through an example. A company ABC has one million shares outstanding and the price of its shares is valued at $5, or a total market capitalization of $5 million (1M shares x $5). If the company went through a 1:10 reverse stock, the amount of shares would decrease to 100,000, while its share price would be at $50. Most reverse splits tend to have very little impact upon the share price and in some cases shares can fall right back down. Such was the case with Citigroup in 2011 when the bank announced a 1:10 reverse stock split.

Dividends

The two forms of dividend distributions are share and cash. Dividends can be paid out to shareholders on quarter, semi-annually or annually. There are also one-time payouts. This was the case with Apple, which paid a one-time extraordinary dividend of $3.29 per share. If you owned 100 shares of Apple, you would have received $329. When a company pays out dividends, it could indicate that the company has got extra cash on hand and financially stable. On contrary, when a company seizes its dividend payout it could signal financial troubles.

The anatomy of a stock dividend is important, especially for those investors that are interested in receiving regular income. There are four dates you should be aware of. Declaration date is the date a dividend is declared as to size of payment and date of payment. On date of record, a company would identify its shareholders. These shareholders will be eligible to receive the dividend. If you are not a shareholder as of record date, you can still receive a dividend if you purchased the shares before ex-dividend date. On ex-dividend date, when shares trade without their dividend, you may expect the market price of the shares to be down by the approximate amount of the dividend. For instance, if $0.50 is to be paid out, the stock price may trade down $0.50 that day. Finally the payment date is the actual date when a payment will be made.

Buybacks

During economic recoveries, share buyback is one way for corporations to utilize their cash on hand. Instead of investing in their own businesses such as inventories, equipment or hiring new employees, the cash is used to purchase some of the shares that are outstanding. This will decrease the pool of shares available. Thus, increasing the earnings per

share. The buyback can also boost the stock price for a short period of time. In the long, however, companies have to find other ways to grow their bottom line. Investors cheered the announcement from the American automaker Tesla, when the company indicated that they would build a manufactory facility worth $5 billion. This could suggest further long-term growth for the company.

Mergers and acquisition

Another corporate event that can also impact share prices is the mergers and acquisition (M&A). In M&A two companies with similar businesses and sometimes different, will merge to create one. One of the companies is said to be the acquirer, while the other is being acquired.

In section 1.2, we indicated that some large companies would eventually reach 'maturity' with respect to their growth. Before and during this stage, companies will look for alternative means to grow their earnings. Instead of pouring cash for buybacks or inventory build up, corporations instead will choose to buy another company. Often times the acquired company would be a competitor or a business that would come as a compliment to the acquirer's business model. Such was the case with recently announced M&A between the Swiss building materials manufacturer Holcim AG and French cement maker Lafarge SA. The proposed deal is worth $43 billion but did not have an immediate impact upon the share price.

Another merger announced in April 2014, between General Electric and French company Alstom SA sent the shares of Alstom up more than 30%, almost overnight. It is expected that the acquiring company would offer some premium above the market price of the shares, to the shareholders of the target company in order to 'sweeten' the deal.

Rights offering

Allows existing shareholders to purchase additional shares of the company, generally at a discount. For instance, an ABC company may offer rights to shareholders at a subscription price of $50, while shares are trading at $53. Let's assume that these rights are exchanged with a ratio of 4:1. This would mean that for every four rights, investors could buy one share at the subscription price. Under the terms, the rights will have an expiration date and investors would need to elect whether to exercise these rights or to sell them in the open market.

Summary

Corporate actions such as dividends, buybacks, rights offering, stock splits and others will have an impact upon the underlying stock price. On ex-dividend date, or without the dividend, the price of the shares could decrease by the amount of that dividend. Buybacks can boost the share price, as companies are buying back their own shares in the marketplace. Stock splits could also show some movement in the stock prices. In a forward split, share price and amount of shares outstanding will also adjust according to a pre-determined ratio. Brokers will normally notify their clients of the any such actions in advance.

Stocks
Chapter 1.4 / Top Down and Bottom Up Analysis

The aim of this section is not to recommend an investment model, which you should follow, but to help you make better decisions when selecting your stock investments. For the purpose, we will present you with two common strategies for evaluations - top-down and bottom-up analysis.

As mentioned earlier, stock performance is affected on a micro level from the company's ability to grow earnings over time. On a macro level, however, corporate results would depend upon the economic environment, i.e. recession or expansion of the economy and certainly by the sector that the company belongs to. The proverb 'A rising tide lifts all boats' refers to the idea that when the stock market or a market sector rises, it would pull the stocks within that sector as well.

What is a top-down analysis?

A top-down approach starts with defining which market sectors are performing better than others. Once you have determined the stronger sectors, you would then move to narrowing it down to individual stocks within these sectors. Stock analysts may also refer to this method as sector analysis. For example, by using various tools such as Saxo Bank's Stock Screener, you can sift through different countries and industries to find strength in the market place.

Let's assume that after selecting criteria such as price performance, the stock screener will filter out the stocks making out the transportation sector.

		Security Name	Last close
	1	Abertis Infraestructuras...	
	2	ADP (Aeroports de Paris)	
	3	Aegean Airlines SA	
	4	Aer Lingus Group Plc	
	5	Air China Ltd	
	6	Air New Zealand Ltd	
	7	Alaska Air Group Inc.	

Now that we have identified strong sectors in the market; we would narrow it down to one or two stocks within these sectors. Our analysis does not end here. If we selected Aegean Airlines, Alaska Air and Air China based purely on how they have performed over the course of 52-weeks, we would then put these stocks on a watchlist and investigate them further. Later in this section, we will cover what to look for in stocks before investing in them.

Although sectors might be labeled differently in Europe or Asia than in the U.S., a developed economy could consist of the following sectors: Energy, Financials, Basic Materials, Industrials, Health Care, Consumer Services, Telecommunications, Utilities, Consumer Goods and Technology. Each sector may consist of several sub-sectors or industries.

Developed economies will generally have large service sectors. In the United Kingdom, the business and financial services sector dominates the economy accounting for nearly 30% of the country's Gross Domestic Product. The sector consists of large banking and non-banking financial institutions such as HSBC, Lloyds and Standard Charted. The energy sector is also a very important to the British economy. Among the largest publically traded companies, part of the Financial Times Stock Exchange (FTSE) 100 Index, are Royal Dutch Shell and British Petroleum. Therefore, at times of economic growth in the U.K., these two sectors would tend to lead the economy. Certainly the opposite is also true- the sectors might struggle during recessionary times.

Which sectors to select and how much to allocate?

It is often a difficult endeavor for many professional and non-professional investors to decide in which sector(s) to invest and when. Industries such as auto manufacturing, housing, retail and others that are part of the consumer goods might suffer when the economy is weak. Weaker economy generally is accompanied by higher unemployment. At times of uncertainty, consumers might avoid big-ticket items such as housing or a new automobile. On the other side, sector like consumer non-durables might fare better during 'soft' economic environment. Most consumers might curb down on their discretionary spending but they would not likely cut down on food or beverage consumption.

How much to allocate towards individual sectors?

Perhaps we have all heard the idiom 'Don't put all your eggs in one basket.' We would like to avoid dropping the basket and crashing all the eggs. Investing heavily in one sector can put a big hole in your portfolio from which you may never recover. Instead, spread your capital over many sectors. If markets are bullish most sectors should fare well. In bearish markets, it is okay to remain on the sidelines holding cash. Cash is a position. You might not achieve a complete diversification using only stocks in your portfolio. Other classes such as bonds, commodities, and cash would be needed to fill in the gap.

Investors might also use the versatility of exchange-traded funds (ETFs) in order to cover different sectors and markets. Being listed on an exchange, these funds trade like stocks but instead of investing in one individual stock, investors will have exposure over a pool of stocks. There are ETFs that track sectors like technology or healthcare, commodities like gold and silver, foreign markets like China or Brazil and other asset classes. Before you use these instruments, please take time to familiarize yourself with them.

Bottom-Up Analysis

While performing top-down analysis may give us a better prospective of the overall strength of a sector in the market, bottom-up analysis focuses on the individual strength of a company. When applying this strategy, investors will look at the overall strength and competitive advantage of the business and then decide on how fairly the market has priced the shares of that company. The last factor is often the most critical one. Are the shares overvalued, undervalue or fairly valued. Some of the basic financial criteria that could indicate the value of a company are price-to-earnings ratio (P/E) and book value (P/B). The yield of a dividend payout could be also important especially if it's above 'average.'

Most brokers and financial media will display this information for you. Let's define what these ratios represent. A P/E ratio is a basic but useful measurement of the company valuation. It simply takes the current market price of the stock and divides it by the yearly earnings. Therefore, if shares are trading at $50 and the company is expected to make $2 per share this year, the P/E will be 25 (50/2). In the above example, shares of Microsoft are trading at 17 times 2015 earnings estimates. The ratio by itself is meaningless. We would need to find out what would be the ratio of the S&P 500 as the stock is part of the index. This would tell whether the stock is relatively cheap or expensive to the overall U.S. market. For example, if the P/E ratio of the index were 20, then we would argue that Microsoft shares are undervalued relative to the market. We could also compare the P/E against the technology sector. For investors making their decision solely on valuation, a lower P/E ratio would suggest the stock price is fairly valued.

The price-to-book ratio is another valuation criteria, which takes the current market price of the shares and compares it to the book value of the company. The book value is calculated by dividing the stock's price into the difference of the company's assets and liabilities (P/B = Price / Assets-Liabilities). Using Microsoft again, the book value of the company is at 4. The number one more time is useless unless we can compare it to another. If book value of the S&P 500 is at 3.2, that may suggest that Microsoft value is overstated.

Summary

The two most common approaches to selecting stocks are conducted by top-down and bottom-up analysis. While top-down starts with a big picture by choosing the 'neighbourhood' of the stock, the bottom-up approach looks at the company's fundamentals. There are certainly advantages and disadvantages of the two methods. For instance, it might be quicker to identify a strong sector in the market while it might not be as easy to arrive to a share valuation. Some investors use a combination approach and use both methods to make an investment decision. Firstly, they would examine different asset classes and sectors before selecting stocks based on their valuation. Whatever method you decide to use, exercise patience and take time to investigate your next investment opportunity before deploying your capital.

Stocks
Chapter 1.5 / Technical Analysis

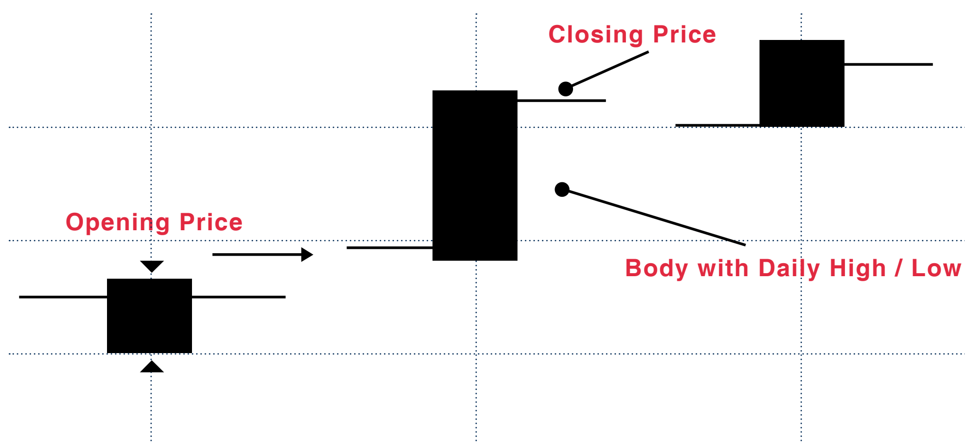
In this section of the course we will learn what technical analysis is and how we can apply it in our trading. We will also introduce rules based strategies to help you with your trading.

If fundamental analysis (bottom-up approach) told us what stocks to buy, technical analysis could tell us when to buy them. Investors using technical analysis rely more heavily on stock charts rather than the valuation of the price. Moreover, technicians will look to gain information directly from the stock price. For these type of investors, it would not matter whether a company beat its quarterly earnings estimates or not, instead they would look at the stock price and how strongly it has moved up or down over the last week. That price action is what catches their eye. Technicians will look for trend and patterns in the price movement.

Technical analysis is based on three premises: prices discount everything, prices move in trend and price patterns tend to repeat themselves.

What is a price?

The price defines the daily action in the market place. A bar price is depicted by a body, range of the daily price and opening and closing tick.



What is a trend?

The general direction of the stock price is referred to as trend. John Murphy in Technical Analysis Of Financial Markets defines trend as an essential tool in technical analysis. All other tools such as price pattern, support and resistance, moving averages have a supporting role. Figure 8, illustrates the upward trend of the Sweden 30 Index. The general direction depicted by the two parallel lines is upward. Technicians will identify three directions of a trend:

- Uptrend
- Downtrend
- Sideway

By definition, uptrend is defined as series of higher highs and higher lows.

On the contrary, a downtrend could be described as series of lower lows and lower highs. In order to confirm a downtrend, investors should look for a lower low, the second point, along the line from where the stock price moves down. Investors should avoid buying into down trending stocks. Instead, focus on the strength of stocks that are on an uptrend. Figure 9, shows downtrend for U.S. oil company Anadarko.

In a sideway trend, the stock price would 'bounce' up and down without within a establish price level. Technicians will refer to this movement as 'consolidation' or 'indecision' in the market. This equilibrium will be disrupted when either bullish or bearish sentiment prevails and the price takes a direction. Investors should avoid buying stocks for which the upward direction is not established. Instead, either confirm that the stock has moved above the restrictive, upper line or focus on a better candidate.

The length of each trend will vary. Charles Dow, the father of technical analysis, recognized three trends in regards to their length: primary or major, secondary and minor. The primary trend can last from a year to several years. The secondary, which is an extension of the primary could last three weeks to three months. The minor or near-term trend typically lasts a few weeks and is part of the secondary trend.

Regardless of whether you are going to trade short-term or long-term, it is always a good idea for novice investors to confirm the primary trend and trade in that direction. The weekly charts should show you at least 2-3 years of price information. Don't fight the trend!

What is support and resistance?

Price will create series of peaks and valleys which technicians will call support and resistance. Support is defined as a level or an area from where price moves up. Resistance, is just the opposite, is a level or an area from where the price moves down. There are horizontal and diagonal levels of support and resistance. The more time the price touches these levels, the stronger these levels could become. Two touches upon such levels would be referred to as tentative support or resistance. Three or more touches would be confirmed support or resistance.

Volume – If price is the rocket, the volume is the fuel to propel that rocket. In this sense, volume is an important factor of technical analysis. When price is move up on an increased volume, it could show great conviction from the side of the 'bulls'. The opposite could be also true; price moving down on an increased could suggest a downtrend in the future.

Moving Averages

A moving average is popular indicator that is used to indicate the overall trend of a stock. The moving average will lag behind the price as it gathers the closing prices of a stock during a particular time frame. For example, a 20-day moving average is used for an indicator of the stock short-term trend. Investors will use a 50-day moving average and a 200-day moving average when the want to confirm more the secondary or the primary trend of a stock. Let's illustrate these using a stock chart of American company Advanced Auto Parts.

You may notice that the 20-day MA, which is the shortest in length, follows the price much closer than the others. This is because there is very little lag between the price and the average. In contrast, the 200-day moving average will have a much bigger lag and therefore would move fairly slowly. From the above chart, we can also conclude that since all three moving averages have an upward slope, investor might take on a bullish trade for short, intermediate and long-term duration. In our next section we will focus on basic trading strategies using moving averages.

Summary

While fundamental analysis focuses on the company's business and valuation of the stock price, technical analysis takes under consideration the price action. Moreover, the main focus of technical analysts will be to study and follow trends. Neither fundamental nor technical analysis has all the answers of the stock market. Therefore, novice investors should use both approaches to investing.

There are three directions of a trend: uptrend, downtrend and sideways. Trend is defined as the general direction of the stock price. According to Charles Dow, there are primary, secondary and minor trends. Each of these will follow a different time frame. Confirming the primary trend of a market or stock will ensure that we are not at disadvantage and should bring confidence in your trading. Identifying support and resistance levels could help you fine-tune the understanding of trends.

Stocks
Chapter 1.6 / Investing Strategies

In the previous section, we introduced and defined some basic, but at the same time important elements of technical analysis. Being able to spot a long or short-term trend, support and resistance, will come with time and practice. Before moving with real trades, test how technical tools work by practicing trades in your 'demo' account. In the following chapter, we will present some strategies for short and long-term investing that you can use as a foundation and expand with time.

Using Moving Averages For Trade Signals

A moving average, as we defined it earlier, is simply an average of the closing prices for the stock. For example, a popular short-term moving average is the 20-day moving average. The prices of the stock over the last 20 days are added and then divided by 20, which results as an average price of that period. When a stock is above its 20-day moving average, technically it would suggest that there is strength in the stock price. Some investors would use this as a buy signal. Investors would exit a trade when the stock moves below its moving average.

In order to confirm strength in the stock price, you should look for the following:

Step 1

Confirm the trend– to confirm an uptrend of a stock you can bring a moving average from the 'Studies' and set it for 20-day period. If the MA is pointing up, the stock is moving on an uptrend. Moving averages do not work well in a sideways market.

Step 2

Support and resistance- always look at these levels, as they are part of a trend. Ask yourself 'where is the stock in regards to support and resistance'. If near resistance, wait for the stock to clear that price level before buying. If near support, let the stock bounce up for a day or two before buying. ALWAYS confirm the uptrend, first.

Step 3

Volume – is the fuel for the stock. When a stock is trending upwards volume should be expanding. Look for spikes in the volume bars especially as the price is moving up.

The above are three simple steps that investors should have as a 'check list' before making a decision to buy a stock. The shorter the length of a moving average, the more trade signals you would experience. By changing the length of the moving average to 50-day or 200-day, you could create a system for longer-term investing. The steps would be the same.

To exit from a short-term trade like the one illustrated, you should watch for a 'reversal 'of the trend. Reversals could occur when the stock moves below its 20-day moving average or starts to 'whipsaw' between support and resistance.

What are Oscillators?

An oscillator is a technical indicator, which could be used, in combination of a moving average to confirm a trade signal. This indicator is referred to as an oscillator as its movements typically oscillate between two areas.

The Moving Average Convergence Divergence is an indicator, which will move above and below a zero line to produce a buy or sell signals. It is a simple tool that shows the relationship between two moving averages. In the example below, these averages have lengths of 26 and 12 days. When they cross a third line, a 9-day moving average, they produce signals. The bars also shown on the graph is another presentation of the movement of the two lines. It is called a MACD Histogram.

The use of the MACD works well in trending markets. Therefore, you should always ensure that the trend is up, before confirming the timing of your entries with an oscillator. For instance, the period from October on is identified with a strong uptrend by the higher highs and higher lows of the price. While during September – October the stock is whipsawing up and down and its moving average is mostly flat.

Other commonly used oscillators are Stochastic and Relative Strength Index (RSI), which could be found in most charts. Let's walk over one more example using a stochastic indicator for confirmation of a long-term entry signal.

Long-term trade example:

Step 1

Confirming the trend – here again you could use a moving average to confirm the trend of the stock. Instead of a 20-day moving average, you should choose a 200-day MA. This moving average would be much smoother than shorter moving averages and would also produce less trading signals. Below, a 3-year daily chart shows how random the signals become using a long-term moving average.

Step 2

Support and resistance – again we would need to ensure that after confirming the uptrend, we are also looking for a recent resistance (peak) or support (valley) and where is the stock price in relationship to these points. Although not as critical when a stock is on an uptrend being aware of resistance, would help you with the timing of your entry.

Step 3

Volume – is volume still increasing while the stock prices is advancing?

Step 4

Stochastic Confirmation – the indicator measures the current stock price to the high and low range during the past 10 days. The stochastic indicator is commonly used to show overbought and oversold areas. A stock is considered overbought when the stochastic reading is above 80 percent. The indicator illustrates an oversold condition when the reading is below 20 percent. As a note, stocks can stay overbought for sometime before moving down. From the graph below we could assume that in addition to a long-term uptrend, the stochastic is confirming an entry as lines of the stochastic are rising are just below 80 percent.

Exits from a long-term position would follow the same rationale: you should exit when the stock moves below its 200-day moving average.

Summary

Deploying technical indicators such as moving average and oscillators should help you make more inform decisions as an investor. Depending on the length of the moving average, you might be in a trade couple of weeks or couple of years. Be patient with your trades and before you enter the market, take time to carefully plan your entries and your exits. Use of a trading journal or a system to record your trades would allow you to have a post trade analysis and improve further.

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