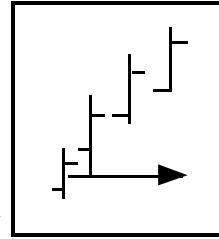


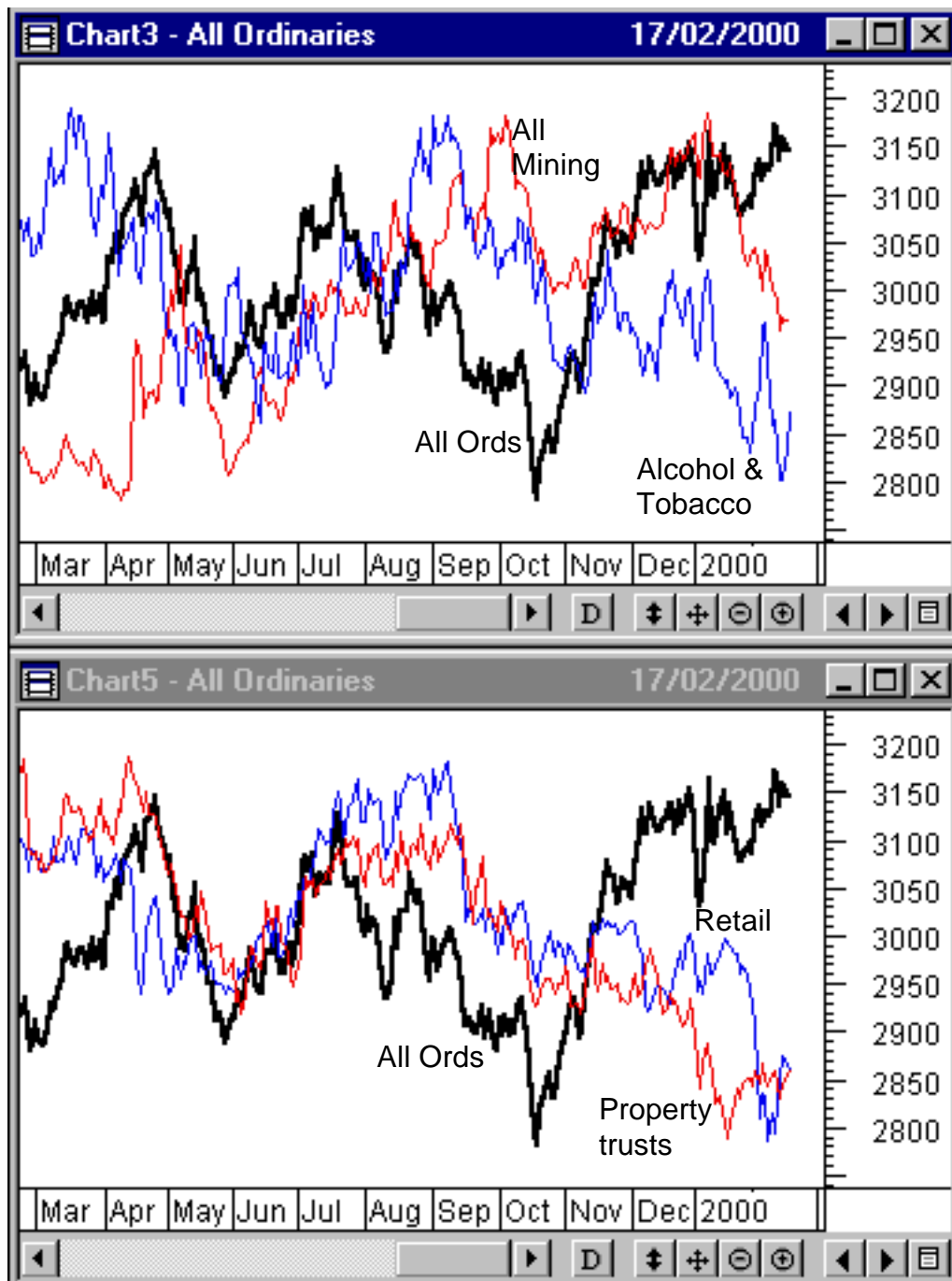
TUTORIALS IN APPLIED TECHNICAL ANALYSIS

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With contributions from G Alexander

MARKET STRENGTH



While there have been many trading opportunities over the past few weeks they have been restricted to just a few sectors. While the All Ords remains the public perception of market strength, it is misleading for serious investors and traders. Its recent performance has been seriously distorted by just one stock -NCP - and this masks an underlying weakness in the overall market. This is one of the reasons why we have not considered a range of popular blue chip stocks in recent months and why the focus has been on trading techniques which are short term and volatility based. Quite simply, we don't trust this market and nor do we feel that the heavyweights have found bottom yet.

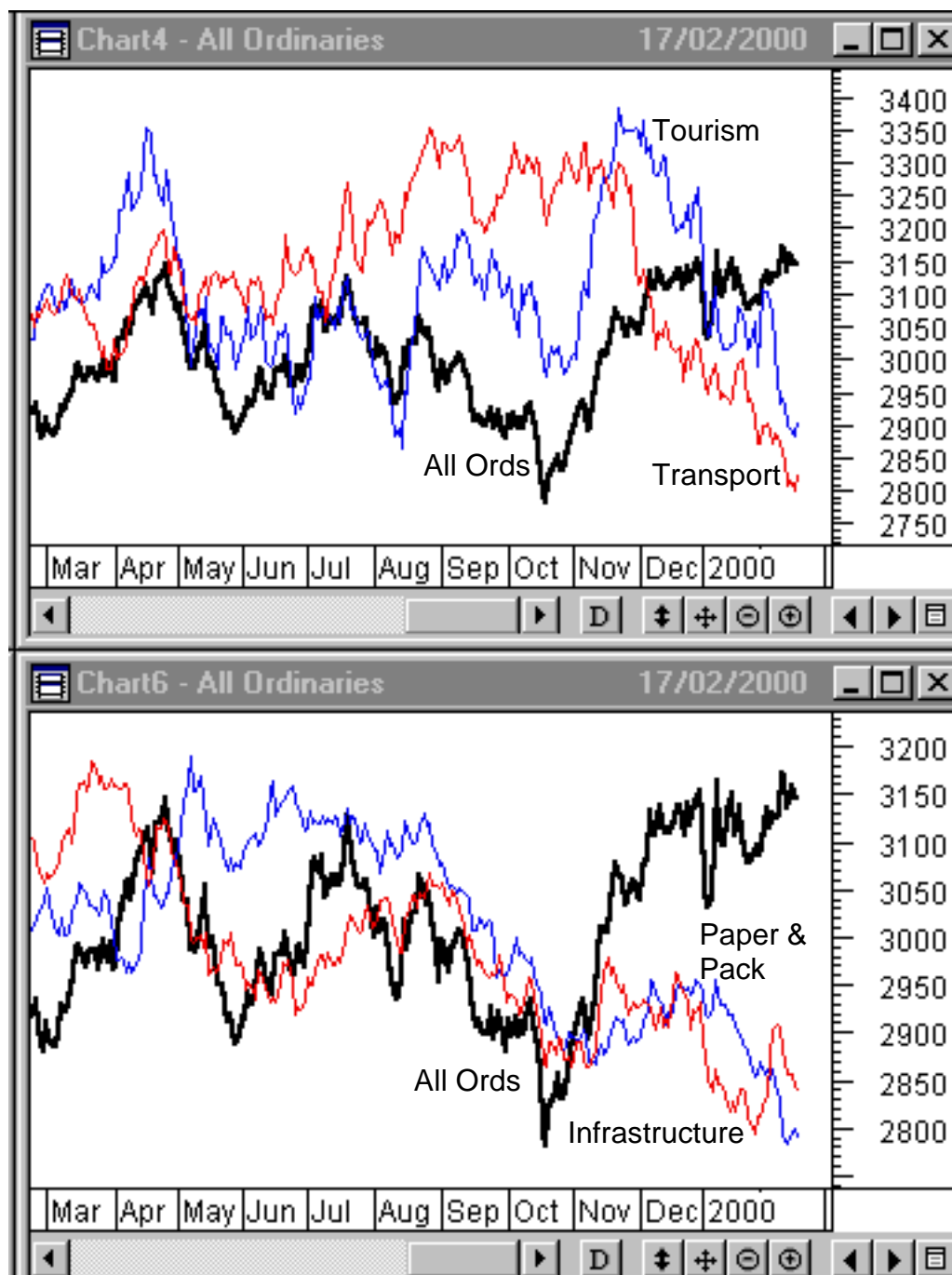
We need evidence for this stance because this perspective helps the trader to select an appropriate combination of tools and to decide which signals should take precedence over others. This is something that trading systems are not very good at. Traders need to adapt to market conditions, using different combinations to make the most effective trades in any set of market conditions. Our evidence falls into two groups.

The first is anecdotal, or observational. In bull markets a little bit of good news drives the market higher. A lot of bad news has very little impact, perhaps a minor retracement. In a bear market, a little bad news drives the market down. A lot of good news barely lifts it. In our market good news is being sold down - dividend reactions are a good example of this. Bad news is being sold down even further - CCL Coca Cola is an example. This is not a bear market, but nor is the bull roaring. We prefer to think of this as a consolidation phase.

In a consolidation phase many stocks will drift towards the bottom of the channel, some showing quite dramatic falls, such as CML. Others will drift sideways for an extended period. We are not particularly interested in these as they can lose trading capital, or tie up trading capital for an extended period. We are interested in those that buck the trend, NCP, PBL and others as they provide opportunities to add to capital. We see these as trading opportunities, taking exits near these spike tops with the intention of buying more stock at cheaper entry prices in the near future. Others may see them as signs of strength and as evidence that stocks like these remain safely in investment portfolios.

The second type of evidence is chart based. The XAO is just one of many indexes and in the chart extracts is shown as a thick black line. It is the sub indexes - the sector searches - that provide a good guide to trading and investment opportunities. Traders look for strength. Investors look for accumulation patterns where downtrends have stopped and smart investors are starting to collect stock at good, low prices. This activity is most clearly revealed in the sector indexes. But this is a further step beyond our initial analysis. A quick survey of the sector indexes shows many of them with signs of top activity and reversal patterns, the beginnings of a downtrend, a well established downtrend, or a sudden collapse. Just a few of them show downtrend reversal patterns. This is a hunting ground for investors and traders. A few of them show strong up trends and these are where the traders focus.

But the majority of market sectors, including those heavily weighted with blue chips, are down and this is not a strong indication of a roaring bull market. We all like trading bull markets, but we all need to know when to sell at the top of a bull market, or a bull leg, to capture profits. Our focus is on both these tasks - trading and the identification of longer term opportunities. The sample portfolio examples show the hazards of trying to identify stocks on the bottom.



Bear Markets

Bear markets are fuelled by fear. Prices start to fall, and continue to fall, despite any good news that is announced. In Australia, these markets fall as investors take a loss, selling at lower prices. For the last 10 years the Index has always closed lower in June making it a 100% bear month. In the US bear markets are more lively because traders can short stocks. They borrow stocks from market makers, and sell them in times of high prices. They repurchase stocks when the prices fall and deliver the new stock to the market maker in replacement of their borrowings. You cannot easily short ordinary shares in Australia so our bear markets are different.

ASSESSING TRADING SITUATIONS

Last week we looked at the first steps in identifying trading solutions. This week we stay with ENE and consider the next steps in deciding if a trading opportunity is presented. We also provide an un-named chart where you can apply the same steps and then compare it with our analysis next week.

In assessing trading opportunities we look for five factors. They are, in order of priority:

- Strength of the support area
- The position of price in relation to support
- The Strength of current trending or momentum activity
- Potential price targets
- Time frame where possible.

Using these factors the trader makes a decision about the probability of the trade failing and his ability to exit with a small loss. If prices have a history of falling rapidly, or gapping where they open much lower than the previous low, then this additional risk is factored into the trading decision.

Next the trader looks at the probability of price targets being achieved. This often uses chart patterns as a measure of reliability. Finally, he looks at the current price to decide if he has to pay this, or more, to get into the trade, or if he can wait for a pullback to lower prices before making a trade entry. Timing is important, particularly for lower priced stocks where a cent or two makes quite a difference because of the leverage. It is less significant for high priced stocks, but it is still much more important than for investing decisions. With ENE leverage is not significant, so an entry within a few cents of the preferred entry point will not have a dramatic impact on profits.

Once we know what we are looking for we then have to select the best indicator to do the job. Note the relationship. We don't find the indicator first and then try to fit stocks to it. When you do this all you find is stocks that agree with indicators and these are not necessarily trading opportunities.

The analysis starts with the strength of the support area. There are two features here. The first is the resistance level at \$10.76. The second is the strong long term support offered by the trend line. A straight edge trend line is a type of support level, and shows a rising level of support over time. ENE has been quite consistent in this, so we can regard this as a long term fail safe area.

If we enter ENE around \$12.00, then trading support is offered at \$10.76. Position size is manipulated late to match this with risk. If we enter ENE around the support at \$10.76, then the next support level used for stop loss calculations is the current value of the straight edge trend line. Unlike horizontal support, this value changes every day, moving upwards.

With two support levels this trade has a reasonable level of safety. The trader has firm points on which the base his risk control measures.

The second factor is the position price in relation to this support level. Some trades rely on entry near support to maximise the trading profits. Here, continuing the analysis based on last weeks chart, price is well above support. While getting in at lower prices is always an advantage, the behaviour of ENE suggests that an entry based on very short term weakness has advantages. Points B and C show this, and a better entry would have been made using the same approach at point D. Price spends a lot of time above support, so buying opportunities based on support factors, either horizontal or sloping trend lines, are comparatively rare. A better strategy is to use support as a safety net below the entry price rather than as an entry point.

Factor three is the strength of current trending or momentum activity. Here we turn to