



## Methodology

In an effort to help you get the most out of this service, I want to give a clear picture of how I trade.

When looking at the market I tend to take a top-down approach.

The first set of indicators I look at is the shorter-term ones. This gives me a sense of what the market direction looks like in the coming week.

Then I look at the intermediate-term indicators. This gives me a sense of whether the short-term move I foresee is sustainable or if it's a countertrend move.

When the shorter-term and intermediate-term indicators are both heading in the same direction (portending a rally or a decline), I search for stock charts that have the best chance of heading in that same direction.

With that in mind, let's take a closer look at some of the major indicators I follow so that you can better understand my thought process.

### **Using Shorter- and Intermediate-Term Indicators**

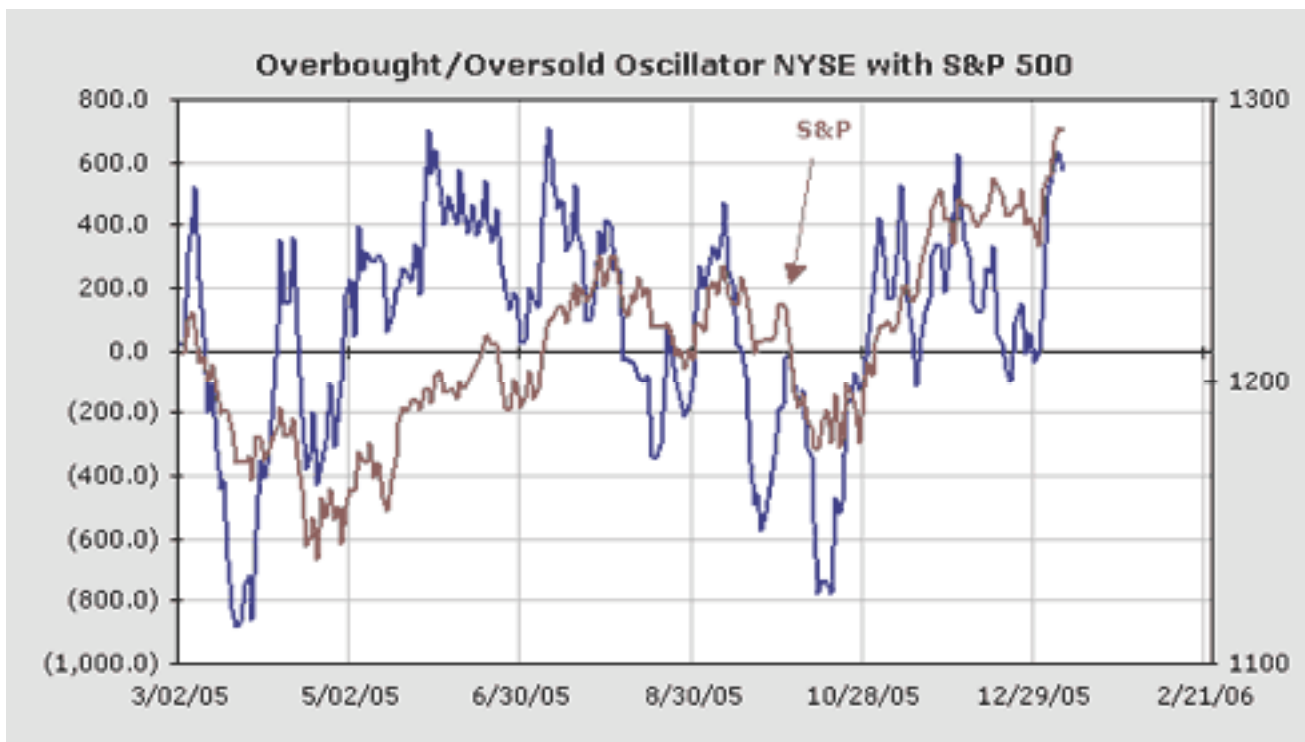
I begin with the shorter-term indicators like the overbought/oversold oscillator.

The oscillator is the 10-day moving average of the net differential of the advance-decline line. This is a momentum indicator, so we are looking for what the short-term momentum is in the market.

For example, if the market has had several down days in a row, because the oscillator is a moving average, we must assume that the market is going to set up such that it will replace (remember, this is a moving average) those negative days with positive days, or at least with less-negative days. That would then make the market oversold.

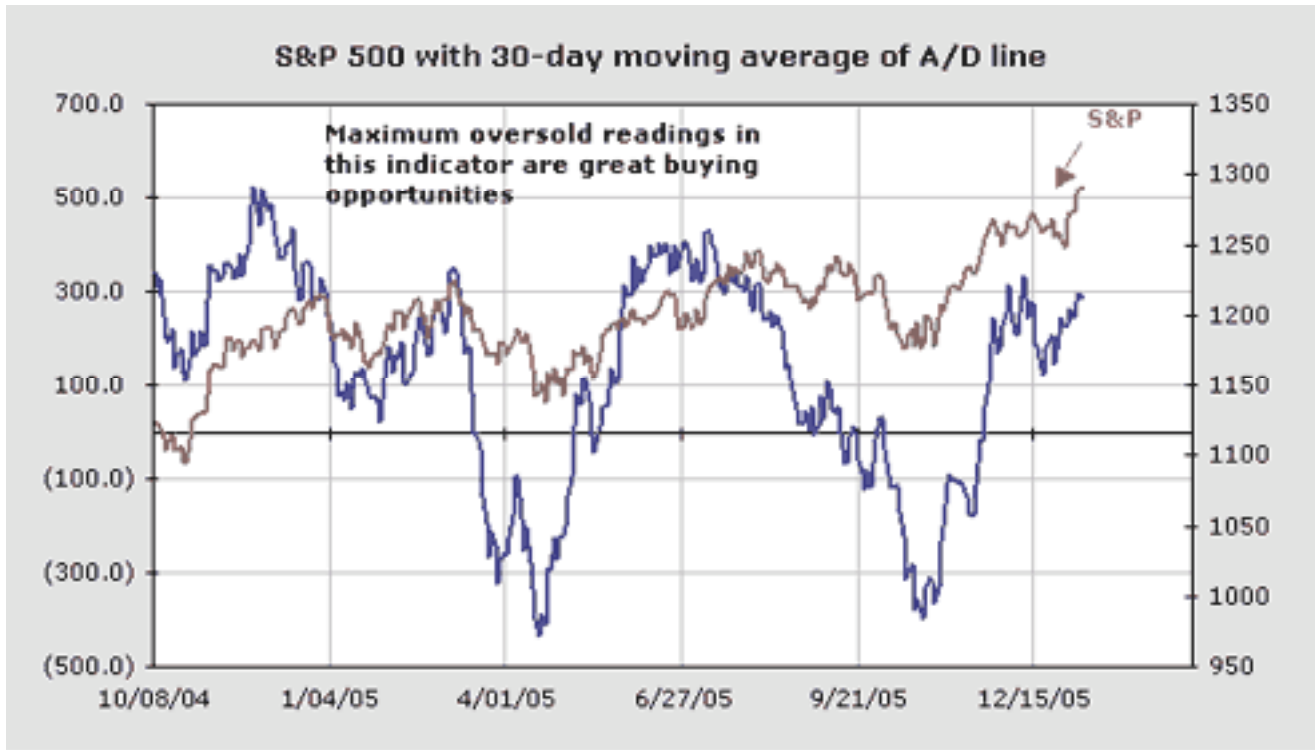
When using the oscillator we also look for divergences. For instance, at the end of a decline and the start of a rally phase, the oscillator tends to give a deep oversold reading as usually there will have been many consecutive down days. That leads to an oversold rally, one that is more typified by a loss of downside momentum rather than a rally with staying power.

When that oversold rally gives up and comes back down, what we look for is a divergence. We want the underlying index average (the Dow Jones Industrial Average, S&P 500 or Nasdaq) to make a lower low than its previous low, and when it does we look for the oscillator to make a higher low. Why? Because that shows a market that is tired of going down, a market that has lost all downside momentum, a market that is ready to rally.



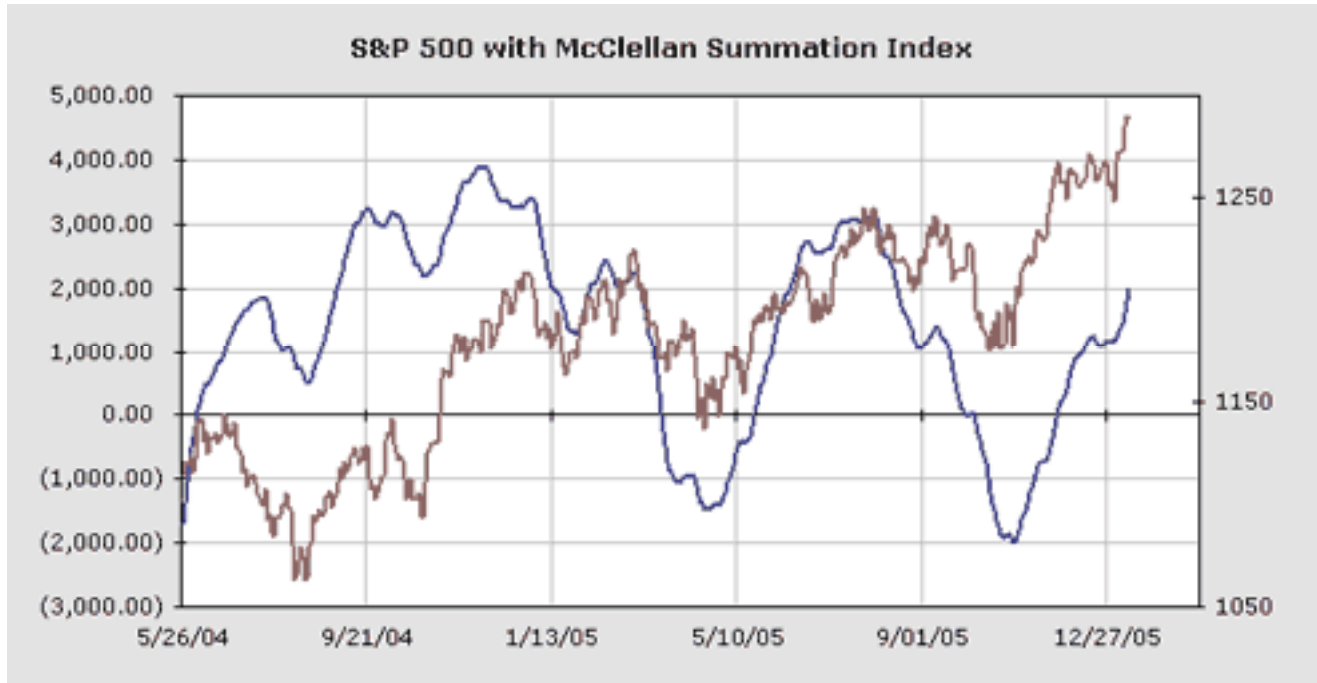
Obviously, the reverse is true at tops: We get a maximum overbought reading, and the market backs off and then rallies again. But if that rally takes the underlying average to a higher high and the oscillator to a lower high, we would then look for a market that is ready to fall.

Using the same statistics, the advance-decline line, I also then calculate the 30-day moving average. This is an intermediate-term oscillator. When this indicator is oversold, it tends to be supportive of the market; and if it's rising, I will err on the side of looking for a rally, as declines tend to be contained in that scenario.



Staying with the advance-decline line, I also use the McClellan Summation Index. Please reread that carefully as I do not use the McClellan Oscillator, rather I use the Summation Index. The Summation Index is a complicated calculation so rather than go through the calculation, let us just think of it as a very smooth version of the advance-decline line.

This indicator moves slowly and does not swing much. We want to err on following its direction. For example, if it's rising, we want to be on the bull side of the market. If it's falling, we should be looking for shorts, not longs.

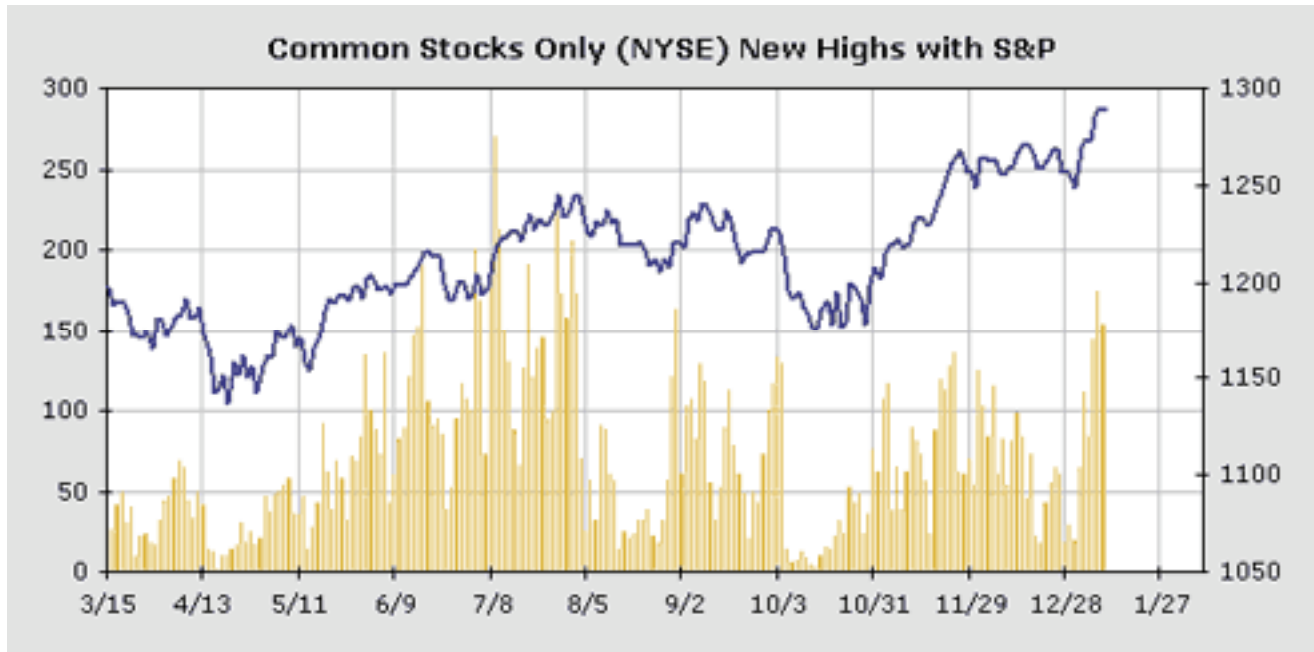


These indicators all use the advance-decline figures, which are also known as market breadth. Another form of market breadth is the number of stocks making new highs and new lows each day. We use these readings for confirmation or divergence.

In a market rally we want to see the number of stocks making new highs increase. If individual stocks are doing well, the market averages will do well and the rally ought to continue. But if the number of stocks making new highs begins to contract instead of expand, it is an early warning sign the rally may be getting tired.

In a downtrend we typically see the number of stocks making new lows expand. If we are looking for a change in trend, we pay attention to this reading. Most often we will see the market index make a lower low and the number of stocks making new lows stops expanding and begins to contract. That tells us stocks are tired of going down and we should start preparing for a potential rally.

Because there are now so many non-operating companies included in the breadth statistics on the NYSE (the published numbers include closed-end funds, preferred stocks and bond funds, among other non-stocks), I now keep statistics on common stocks only. I will refer to these on a regular basis in the newsletter.



Another aspect of market breadth is volume. As it is an important factor in the markets, I monitor many aspects of volume, but the indicator I find most useful for an intermediate-term move in the markets is derived by taking the percentage of upside volume plotted on a 30-day moving average.

When this indicator gets down to the low 40% area, the market tends to be closer to a bottom than a top. At that point we should start focusing on when the oscillator will next be oversold, as I will be looking for stock charts that should be bought for the upcoming rally. When this volume indicator gets over 55%, the market tends to be close to the end of a rally.

This is a good point for me to point out that there is a big difference between market highs and lows. It is human nature to want to buy, not sell; therefore bottoms can form in a day, but most often it takes tops significantly longer to form. So when I say that we are late in the rally, it means I no longer want to be buying stocks. First the indicators stall out; and then at some point, after these indicators stop going up, all these indicators will start rolling over with stock charts following. That will be the point I want to start shorting.



### Monitoring Market Sentiment

This brings us to a discussion of sentiment. I put a lot of emphasis on sentiment in my market outlook. I am a strong believer in contrary investing. When there are too many bulls, I wonder who is left to buy. When there are too many bears, I wonder who is left to sell.

Granted, there are long periods of time when the trend is your friend and it does not pay to be contrary. But when the sentiment indicators are at or near extreme readings and the other indicators are lining up with them, the market is gearing up for a turn.

On a daily basis I follow the put/call ratio. My thought process is that folks who are bearish buy puts and folks who are bullish buy calls. So a low put/call ratio means there are too many call buyers vs. put buyers, and is considered bearish. Because you cannot judge a whole market on a one-day reading, though, I will tend to smooth this indicator out and plot it on a 10-day moving average.

When this moving average rises to the top of the chart page (there is no definitive level, but it becomes obvious on the chart), there are too many bears. When it falls to the bottom of the page, there are too many bulls.

The Investor's Intelligence readings are weekly. There are many market participants who complain that this sentiment indicator is no longer useful because so many watch it. My answer to that concern is that this reading is one of the oldest sentiment indicators out there — it's been around since the 1960s -- and I have rarely seen a market bottom or top where this indicator hasn't given us a signal. There are too many bulls at the highs and too many bears at the lows.

Another weekly sentiment indicator is the American Association of Individual Investors. I have found this indicator useful at times, but my big pet peeve when it comes to this reading is that these folks call themselves investors yet they jump around from bull to bear in the course of a few days! Therefore this indicator needs to get to a major extreme and needs to be confirmed by at least one other sentiment indicator for me to make a big fuss over it.

The Market Vane Bullish Consensus is a survey of traders. Readings up in the 70% range should be considered too bullish and are warnings we should no longer be chasing rallies. The lower end, however, is not as easy to interpret as it once was. There was a time when a reading under 20% meant it was time to buy, but we haven't seen a reading under 20% in years.

For decades I have followed the Specialist and Members short ratios on the NYSE. And over that time these two indicators have been quite useful. However, with the changes taking place at the NYSE in 2006, I will reserve commenting on them until they once again prove their usefulness.

Finally, once a month, the financial services firm UBS surveys its clients and publishes a figure called "Investor Optimism." I have found this particular indicator to be useful in the few years I have been tracking it. The clients tend to be too optimistic at market highs and too pessimistic at lows. I haven't yet found the exact levels, but when the figures are plotted on a chart it's easy to see the peaks and valleys.

### **Tracking Individual Charts**

By hand-posting approximately 200 stocks each day I gain insight into what individual stocks are doing. For example, sometimes the advance-decline line provides a reading of 2,000-1,000 (or 2:1), yet when you put your pencil to the paper you see that the advancing stocks were up only a penny or two that could barely be noticed on a chart.

The charts I post are semi-logarithmic, which means that I am charting the price (and volume) movement, but a dollar move on a \$20 stock is not the same return on capital as a dollar move on an \$80 stock. In fact, for a \$20 stock to have the same look on the chart as an \$80 stock, the \$80 dollar stock will have to move \$4 for every \$1 that a \$20 stock moves.

For example, Google (GOOG:Nasdaq) trades around \$400 a share and Yahoo! (YHOO:Nasdaq) trades around \$40. Would you go ga-ga over a \$1 move in Yahoo!?! But yet folks go ga-ga over a \$10 move in Google. On my charts the two moves would look exactly the same.

Each day as I post my charts I write down the bullish ones on one side and the bearish ones on the other. I post the charts alphabetically so that I'm not focusing on one group at the same time. At the end of the chart session, I look at the list and the first thing I note is which side is longer.

Then I see if any groups stand out. After that I review the names I've written down and have a closer look. Those stocks that appear positioned for an imminent breakout are the ones I favor most. I prefer to anticipate a breakout rather than chase one.

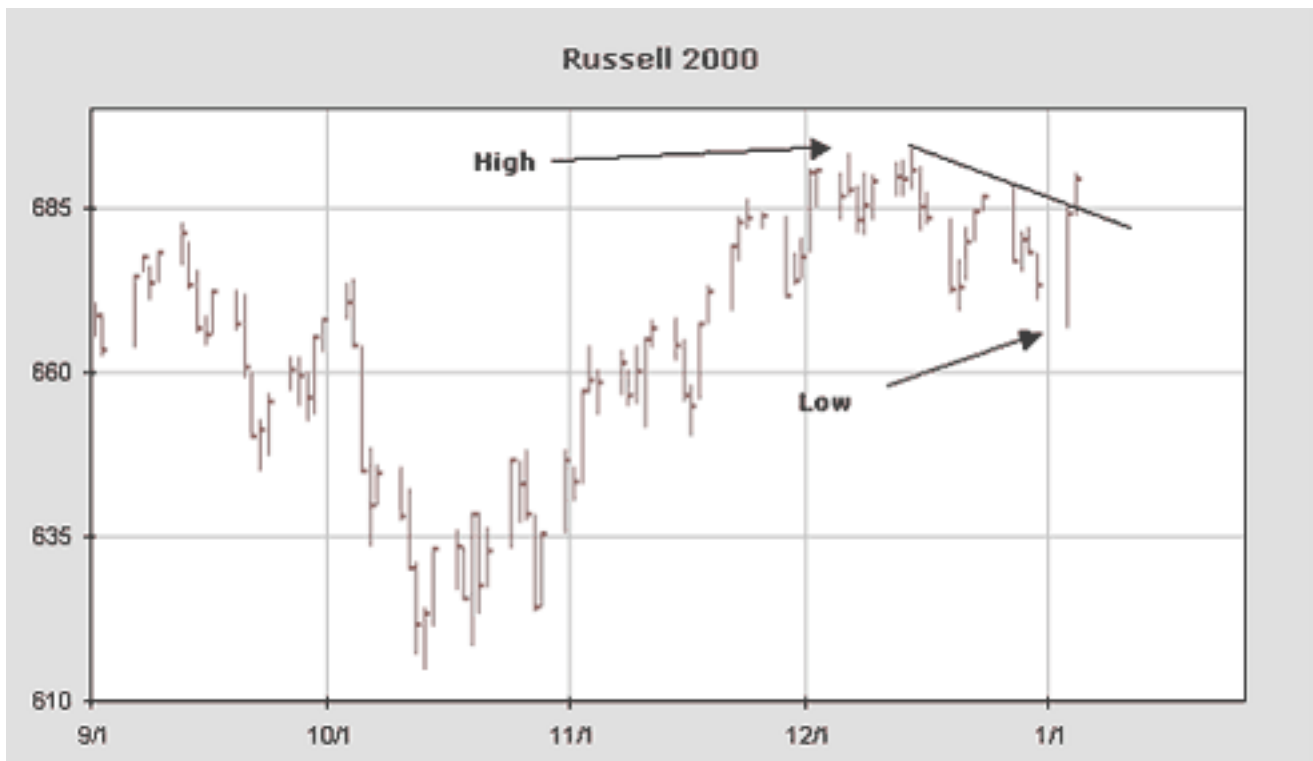
Because I am anticipating the breakout, I can tend to be early in my stock calls. What does that mean? It means that it will often take several days for the stock to start moving. The advantage of this approach for you is that you will have time to do your own research, to look at the stock yourself and make an educated decision, rather than a hasty one, about the pick.

I do not expect my stock picks to work out in the course of a few days. I do expect them to work out over the course of one week to a month.

In terms of using stops, I like to set them with some leeway to shake out weak holders. So if I'm suggesting a short and the previous high is \$20, I might use a stop of \$21 rather than \$20 as often the shorts get run in only to have the stock reverse and do exactly what you thought it would. The same is true for longs as we often see false breakdowns that then reverse and the stock heads upward.

To calculate targets, the first target I look for is support or resistance, or an uptrend or downtrend line. That's easy. But after the stock has passed those obvious levels, I do a back-of-the-envelope calculation.

For a bullish chart I take the high of the pattern and subtract the low of the pattern. I take that differential and add it to the point of the breakout. That gives me the target price, which is a general area, not a precise target. But I have found over the decades that I've used this calculation that it has managed to give me a good general idea of where the stock should stop and at least rest.



So to recap, I begin by generating a top-down view of the market based on short- and intermediate-term indicators and sentiment. Then I find the stocks that are trending in the same direction as the market, and have the best chance of outperforming the index averages.

Now let's get started!

## Contact Info

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