Advance-Decline Line Follies

***e*Research Corporation** is pleased to provide a weekly commentary, authored by Tom McClellan, entitled "The McClellan Chart-In-Focus", which is a free technical analysis article published each week.

In this article, Mr. McClellan examines the pitfalls of monkeying with the A-D Line.

The article is reproduced below, beginning on the next page, or you can use this link to go to the article directly:

http://www.mcoscillator.com/learning_center/weekly_chart/why_dont_we_use_just_common-only_a-d_numbers/

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Bob Weir, CFA
Director of Research

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The McClellan Chart-In-Focus

by Tom McClellan (bio at end)

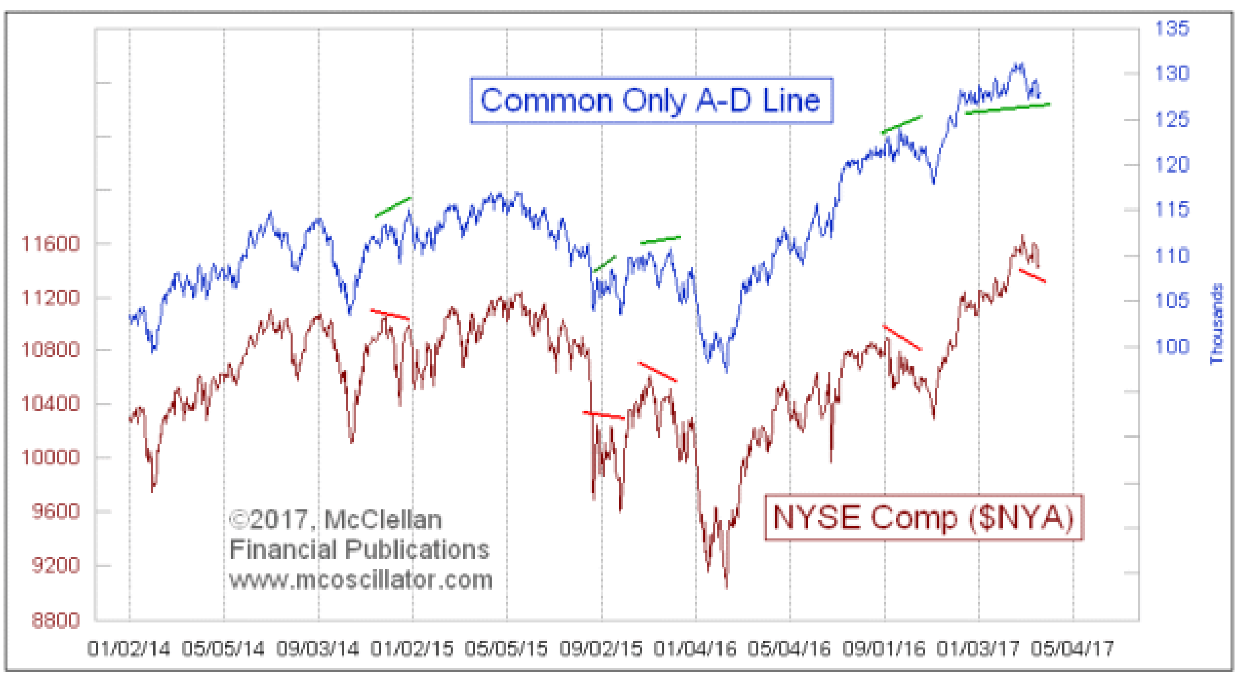
For as long as there has been Advance-Decline (A-D) data that people have been interested in following, there has been criticisms of that very same A-D data for including "the wrong sorts" of issues.

Back in 1962, Joe Granville and Richard Russell both pointed to the big divergence between the NYSE A-D Line and the major averages like the DJIA. That divergence preceded a 27% decline in the DJIA, so in that moment the A-D Line suddenly became much more interesting to a lot of people.

But critics noted then that the NYSE-listed issues contained utilities and insurance company stocks which were "interest rate sensitive", and which were supposedly contaminating the data. The same criticism persists today, but now it is leveled against preferred stocks, bond related closed end funds (CEFs), and other issues that trade like stocks on the NYSE. Those other issues make up about 40% of the issues, although they trade only a small fraction of the volume.

Many analysts assert that one should preferentially follow the A-D numbers for "common stocks", sometimes referred to as "operating companies only". This distinction supposedly filters out those damned contaminants. So, everyone would supposedly be happier and better off if they just followed the right sorts of data, and ignored those "others".

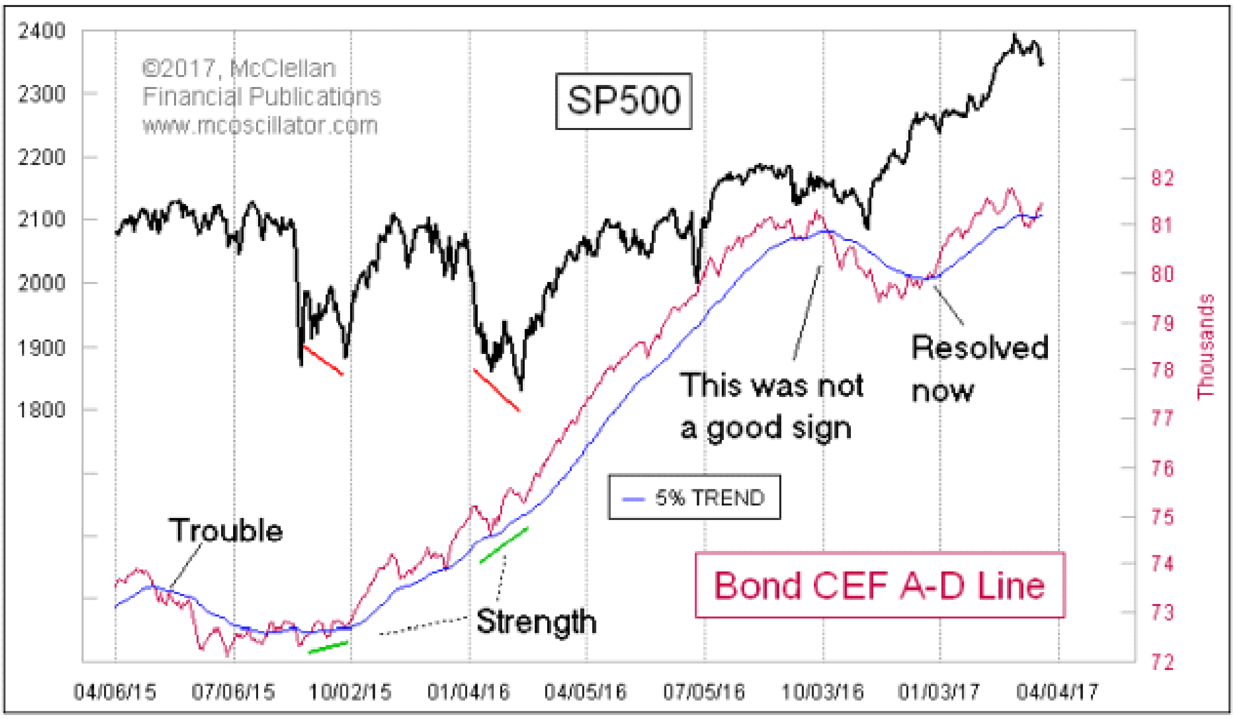
The problem is that the purified A-D data are actually not always better. The chart below shows that when the Common Only A-D Line disagrees with the NYSE Composite Index, it is usually the price index that ends up being right. **This is a big problem.** The whole reason for hiring an A-D Line to work for you is to give you a different answer from what the price indices are saying. Having an index give you the same message that prices give you is useless, and having data that give you the wrong answer at a pivotal time is worse than useless.



The one type of issue on the NYSE that is most often blamed for contaminating the A-D data is the closed end bond funds. They only make up about 7% of the listed issues, and hardly trade any of the volume, but they are continually trotted out as the "usual suspects" for messing up the A-D data.

This is problematic both from the standpoint of raw prejudice and, more importantly, because it is just not true. These issues tend to be the better canaries in the coal mine, warning of trouble ahead when such warnings come from the common-only A-D data or other indications.

This next chart shows an A-D Line for the Bond CEFs, those supposed contaminants of the A-D data. The point is that this Bond CEF A-D Line often tends to be a better indicator of liquidity for the stock market than the data for the actual stocks. This point is counterintuitive, we know, but that is what the data show. So what are you going to believe: your preconceived notions, or the actual data?



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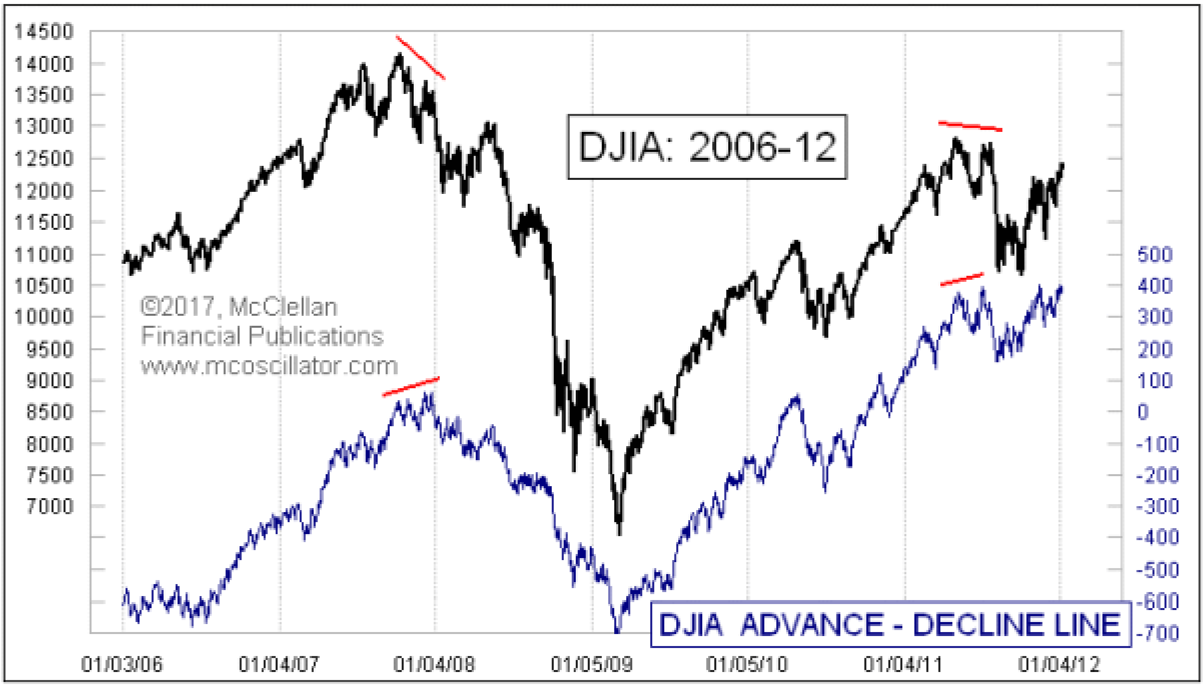
What about just following the A-D data for the components of a particular index? This one fails the usefulness test as well.

Here is a chart of the DJIA compared to an A-D Line made up of just the 30 Dow components:



At the left side of the chart, the DJIA topped out on Oct. 9, 2007, but its A-D Line kept making higher highs until Dec. 10, 2007. Not only was there no bearish divergence, the A-D Line was wrongly saying things were fine as a bear market was starting. And the same thing happened again in 2011 at the right end of the chart.

The whole point of watching A-D data is to get a different and better answer about what the future holds. We want to see divergences, especially at price tops, to tell us that trouble is coming. But when the DJIA itself makes a lower high and its A-D Line makes a higher high, that is a message one is better off not listening to. Instead, one should turn to better "experts", who know what lies ahead.

I once believed, as others still do, that it was better to purify the A-D data, to get the "better" answer. That is why I went to the trouble of writing all the code (with help from others, thanks R.N. and crew) in order to gather and arrange these data, in pursuit of those supposedly better answers. Then I tested that hypothesis, and I found it wanting. So, if one is going to follow the scientific method, a re-evaluation of the hypothesis is required whenever the data do not support one's hypothesis.

It turns out that the parts of the A-D data which so many people criticize for being "impure" actually seem to have the better answers a lot of the time. It is as though the chaff may be more valuable than the wheat. Think of this next time you hear someone tell you that you should only use data for the common stocks. That is a prejudiced viewpoint, stemming from assumptions rather than examinations, and which the data do not support.

Tom McClellan

Editor, The McClellan Market Report

BW: Information on Tom McClellan and *The McClellan Market Report* and *The Daily Edition* follows on the ensuing page.

ABOUT THE AUTHOR

Tom McClellan

Tom McClellan has done extensive analytical spreadsheet development for the stock and commodities markets, including the synthesizing of the four-year Presidential Cycle Pattern. He has fine-tuned the rules for inter-relationships between financial markets to provide leading indications for important market and economic data.

Tom is a graduate of the U.S. Military Academy at West Point, where he studied aerospace engineering, and he served as an Army helicopter pilot for 11 years. He began his own study of market technical analysis while still in the Army, and discovered ways to expand the use of certain indicators to forecast future market turning points.

Tom views the movements of prices in the financial market through the eyes of an engineer, which allows him to focus on what the data really say rather than interpreting events according to the same "conventional wisdom" used by other analysts.

In 1993, he left the Army to join his father in pursuing a new career doing this type of analysis. Tom and his Father spent the next two years refining their analysis techniques and laying groundwork.

In April 1995 they launched their newsletter, The McClellan Market Report, an 8-page report covering the stock, bond, and gold markets, which is published twice a month. They utilize the unique indicators they have developed to present their view of the market's structure as well as their forecasts for future trend direction and the timing of turning points.

A Daily Edition was added in February 1998 to give subscribers daily updates on their indicators and also provide market position indications for stocks, bonds, and gold. Their subscribers range from individual investors to professional fund managers. Tom serves as editor of both publications, and runs the newsletter business from its location in Lakewood, WA.

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