



## MARKET COMMENT

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### How to Tell if the Trend Is Truly Your Friend

By: Ari Charney

Some investors believe a price chart tells you everything you need to know about a stock. Why waste time learning about the company's products and markets? Or its profit margins and debt load? To a point, they are right.

In a sense, the share price encompasses everything the market knows (or, at least, thinks it knows) about a stock and where it's headed next. In other words, the trend is your friend ... until it is not.

That is why so many trading systems use momentum-based strategies. The thing is, momentum works. While such strategies may focus on the short term, the very best can generate long-term market-beating returns ... while lowering risk.

#### The Blended Trend

When I used to track investment newsletters for a living, one early momentum investor had already racked up decades of market-beating returns. It was done by trading in and out of mutual funds, not stocks. Their secret sauce is a proprietary formula that blends momentum over the trailing one-, three-, six- and 12-month time periods.

Now, momentum is just a fancy way of referring to the speed and extent to which a stock or fund's share price moves up or down. Obviously, momentum investors want to find short-term winners that are likely to continue heading higher. The tricky part is how can you tell when momentum is about to start flagging? After all, it takes time for a security to exhibit strong upward momentum and, by the time you have identified it as a potential candidate, the trend may be about to reverse, leaving you stuck with a loser.

So, timing is of paramount importance.



That is one of the reasons why the fund letter I mentioned earlier averages performance over short- and medium-term time periods.

If a fund produced a winning performance over the past 12 months, then that sustained move should be strong enough to lift it higher for even longer ... most of the time. But every hot hand eventually cools. One way to make sure the trend is likely to stay intact is to take more recent performance into account.

## **A Personal Twist**

To this end, my colleague, Jim Fink, has an intriguing twist on the usual blended approach to momentum. As Investing Daily's resident options guru, Jim uses momentum as part of his five-step methodology for *Velocity Trader*.

Like other traders who use momentum, Jim looks at how a stock has performed over the past 12 months. Of course, he also looks at how it did over shorter-term periods.

In contrast to other strategies, however, he actually penalizes stocks whose strongest gains occurred most recently. Jim's contrarian approach dovetails with what academic research has shown. Stocks that have strong gains over a very short period are more likely than not to retrace that movement. In other words, a stock only has so much power, and when it makes a big upward move in a short amount of time, there is a risk of exhaustion ... and a move back down. To guard against this possibility, Jim created a proprietary metric called "*Flare-Out Growth*."

Basically, it looks for stocks that have made strong gains on a sustained basis, but then removes those at risk of burning out because they have moved too high, too fast. While lesser trading services rely on momentum alone, Jim does not stop there. His investment process includes four other steps that require a similarly obsessive attention to detail. Jim's incredible focus is coupled with an equally incredible work ethic. Along those lines, I would like to share a brief anecdote about Jim.

Last weekend, I was at the office on a Sunday afternoon, but accidentally left my key inside when I left for a short break. While others would just go home at that point, I couldn't afford to be locked out. I had a newsletter scheduled to go to press the next morning—and I couldn't finish that work from home. In a total panic, I called Jim to ask if there was some way he could drop by the office and let me back inside. When he arrived, I thanked him profusely. But he shrugged and said, "I needed to come here and do some work anyway."

He actually stayed and did a few hours of work—probably making further refinements to his five-part trading system—on what could have been just another lazy Sunday afternoon.

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