Unlock Quick Profits With Technical Trading

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Unlock Quick Profits With Technical Trading

By Scott Chan (see bio at end)
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Buy-and-hold is not for everybody. If you want the key to quick money, consider technical analysis. Below, I explain how it is done.

One of the most frequent questions that I get from readers is about the difference between investing and trading. The distinction is not always clear cut. Generally, the primary difference is in the time horizon. Investing is long-term, trading is short-term.

In the long run, the stocks of high-quality companies usually out-perform those of mediocre or poorly run companies. Consequently, market participants with a long time horizon usually choose stocks with strong fundamentals. They are looking for stocks that will make gains over months and years.

Quick Trades For Quick Profits

Other market participants, however, like more action. They want to beat the buy-and-hold strategy. They try to make more trades and be in and out of a stock in days and weeks (perhaps even seconds). They want to make as much profit as they can in as short an amount of time as they can. These folks are traders.

Because traders do not have time to wait for a company's fundamentals to win out, they tend to make their trading decisions based on the analysis of a stock's price movement. This is called technical analysis.

At the heart of technical analysis, traders are trying to analyze the market supply and demand for a stock to predict the direction of that stock in the very near future.

You may have heard traders talk about "Mack-Dees" before. What they are talking about is “moving average convergence divergence” (MACD). It is an important indicator that traders use to determine a stock's momentum.

Spotting Momentum

To put it simply, MACD is the relationship between two exponential moving averages (EMA) of a stock price. An EMA is calculated by adjusting the simple-moving-average (SMA) calculation to give more weight to recent price data. The EMA reveals short-term trends earlier than an SMA would.

Now, to calculate the MACD, you subtract a stock's 26-day exponential moving average (EMA) from its 12-day EMA. A positive value for MACD indicates increasing upward momentum, and a negative value indicates decreasing upward momentum. Traders also use a "signal line" as a transaction signal. The signal line is simply the 9-day EMA of the MACD.

If this sounds too complicated, don't worry. Most charting software programs are already pre-set to allow you to display a stock's MACD without any calculation on your part.

The graphic on the next page is an example of what you would typically see:

The top part of the graphic is a bar chart of **Invesco QQQ Trust's** (NSDQ: QQQ) daily price movement. The bottom part plots the MACD.

The black line is the plot of the MACD. The red line is the signal line. The green bars indicate the difference between the MACD line and the signal line. The important part that traders look at is the relationship between the black and red lines.

Catching the Momentum Shift

The MACD line fell below the signal line in mid-January 2009. To technical traders, that is a sell signal. On the other hand, in late January, the MACD crossed above the signal line; that is a buy signal. However, indicative of the wild market at that time, the MACD quickly fell under the signal line again and a few more cross-overs occurred until the MACD crossed over the signal line in March.

If you still remember, the stock market bottomed in March 2009 and has been on a roll since. Traders who bought stocks based on that bullish crossover in March would have caught the market at its bottom.

Of course, even though traders widely use MACD, it is not perfect. It can give false signals that cost you lots of money. And using technical analysis to trade is not as easy as just blindly following a chart. It takes considerable experience to use MACD and other technical-trading signals properly to achieve a balance of making money and managing risk.

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ABOUT THE ANALYST

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Bio | Archive

Scott Chan moved from China to the U.S.A. with his family at the age of ten. He passed the rigorous entrance exam and attended the merit-based Stuyvesant High School, widely held to be the best public school in New York City. He earned undergraduate degrees from New York University followed by an MBA degree from the Zicklin School of Business at Baruch College.