Herald Sun

Divining the clear-cut conditions for when to pounce

TERMS OF TRADE

with CARL CAPOLINGUA

FOR many, a methodology for entering an investment is the most exciting part of investing as we love the thrill of the chase.

Like a child in a candy store an investor with a nest egg is spoilt for choice in the markets. There are well over 2000 companies listed on the ASX and many tens of thousands around the world. Many of these earn profits and pay dividends, and many are household names.

But which are likely to deliver the best return in terms of capital growth, a regular income stream, or our desired combination of both?

I am a systems-based technical analyst.

Therefore I have devised a clear-cut set of conditions that must be met in the benchmark index, and in the market, for a specific security before I am able to invest.

Each condition is based on what can be explicitly observed on the price charts of the broader market and the security in question.

There's no grey area as to whether an investment opportunity exists. I don't decide on whether to buy a stock or not — the system does. I just follow the system.

My brand of technical analysis is based upon pattern recognition.

It assumes there are patterns in how price moves over time which repeat with enough statistical expectancy that one can profit from entering and exiting when the patterns exist.

Let's start with a possible pattern and work backwards to explain its key points.

Suppose a simple (hypothetical) pattern is: When today's close is within the top 10 per cent of today's price range, and today's price range is greater than 150 per cent of the average daily price range over the past six months, there is a 68 per cent probability tomorrow's price is at least 5 per cent higher, a 16 per cent probability tomorrow's price is between the same-to-less than 5 per cent higher, and a 16 per cent probability tomorrow's price is lower.

Note the pattern has absolutely strict conditions for identification. For example, today's close can be explicitly measured against today's range, which itself can be explicitly measured. Therefore there is no confusion as to whether a pattern has occurred.

We seek to observe the pattern many hundreds of times along with what occurs afterwards.

Next we calculate the probabilities of certain events occurring post-pattern.

Armed with this knowledge the next time we observe the pattern, we know with great confidence the pattern's expectancy, that is, the likely return on each dollar invested over a very large sample of patterns.

We only look to invest in patterns that have the greatest expectancy.

This is clearly a very short-term pattern, but I have used the same approach to research longer-term patterns with positive expectancy.

Various patterns contribute to a system of entering the market that leaves no question as to whether a valid opportunity exists, and the likely profitability of the opportunity.

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