



ClearStation Education: Using ClearStation

Version 2.0
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Using ClearStation

ClearStation is an extremely comprehensive site. We work hard to give you exactly what you are looking for, but with all the information available, it's natural to feel overwhelmed... especially if you are new to technical analysis or to the Web.

It's not as hard as you think! In fact, it's not hard at all. All you need is a little time to browse and get familiar with the site - and the patience that's part of every learning process.

In this section, you'll learn:

- How to get the most out of **Recommend**, **Portfolio**, **Tag & Bag**, and **Focus**
- How to use the **Member Discussions** to your greatest advantage
- How to adapt the **3-Point Investing** strategy to your trading

Focus Highlights by kathia

Focus is the headquarters of your ClearStation account. It provides a quick overview of your Portfolios and Watch List as well as a brief rundown of other hot tidbits from the rest of the site.

Focus summarizes the rest of the site; rather than visiting many separate places to gather information, you can start at Focus and skim through what is pertinent to the stocks you're interested in.

At the top of the page you have a list of your portfolios and how much they have gained or lost for the day. Next to that is a long list of events—technical and fundamental—related to the stocks in your portfolios and Watch List. After that you have a bunch of stats on these stocks, followed by highlights from other areas of the site.

Focus is extremely useful. It saves you from constantly having to look at your portfolio and Watch List performances. And the events list is valuable! Nowhere else can you get such a quick review so easily.

- Focus makes it easy to keep track of stocks you're considering investing in—just add the stock to your portfolio or Watch List, and it lands on Focus complete with relevant items.
- One of ClearStation's best features is its stock screening tools as exemplified by the **A-List**. The A-List is the cream of the crop of top-performing stocks according to a multitude of criteria: from stocks that are trending hard to stocks exhibiting earnings surprises.

Use the A-List on your Focus page to grab new investment ideas! Many successful recommendations have been plucked directly from the A-List. Add individual stocks that interest you to your Watch List or create a tracking portfolio to follow an entire A-List that looks enticing. (The stocks will appear in the Portfolio and Watch List summaries at the top of your Focus page.)

Getting the Most Out of Recommend by kathia

One of the privileges of ClearStation membership is access to a large community of passionate investors willing to share their views and knowledge with you.

The hub of community activity is located within the Recommend area. Recommend is a feature unique to ClearStation: it hosts lists of member-recommended stocks.

Let's back up a second. Upon registering, you are automatically set up with a "recommend" portfolio. While any other portfolio you create is completely private, as soon as you add a stock to your "recommend" portfolio any other person using the site can review it. The stocks you enter here are stocks that you would like to recommend to the rest of the community, and your "Recommend List" is then accessible to all. (If you do not wish to make any recommendations that's fine—participation is not mandatory.)

Equally, you can peruse the lists of other members. If you notice that one member has great picks, you can subscribe to his/her list. That means that whenever that member makes a recommendation you are notified of it by email (if the person makes no comments with the recommendation an email is not sent). There is no charge for subscribing to anyone's lists, and you can unsubscribe at any time. (When you first register, you are automatically subscribed to "kensey's" list as an introduction to Recommend. [kensey](#) is one of the founders of ClearStation and the chief analyst on the site.)

Do you understand the power of being able to subscribe to someone's Recommend list? It allows you to find a high-performing portfolio and follow it along in detail. Not only does this let you learn from other traders who may be more seasoned than you, but it also provides you with a vast number of new investment possibilities.

When a member makes a recommendation, you should not view it as a declaration that you need to get on the phone with your broker and purchase shares of the stock now. Recommendations should be taken as food for thought. Make your own decisions—don't blindly follow someone else's suggestions.

In Recommend, the member lists are broken down into three categories: lists you are subscribed to, lists of the ClearStation core members, and the top-performing lists of the day.

- To be included on this page, lists have to contain at least four stocks. Even if a list has high gains that are competitive with other lists, it will not be included unless it has at least four stocks.
- To see the actual list, click on the member's username.
- Want to see a Recommend List that isn't on the page? Just enter the correct username in the search box at the bottom of the page. Be sure that you type in the username correctly—the system is case-sensitive!
- All lists are sorted according to how much they netted for the day. You can change this order by clicking on the column header links. For example, if you wanted to see the lists the have the highest average % gain you would click on "avg % gain."
- Recommend Lists you are subscribed to are at the top of the page to give you a quick look at how they are doing. You can subscribe to an unlimited number of Recommend Lists.
- Next you have the ClearStation core. This group consists of members chosen by kensey for a number of different criteria: good performance history for their recommendations, descriptive explanations, and active participation to name a few. For the most part, the ClearStation core are

just members and do not work for ClearStation; however, employees of the site have been included in this group at various times.

- The last set of lists is the top-performing Recommend Lists of the day. Remember that you can sort the lists differently by clicking on any column header link!

Bring Your Own Soapbox: Member Discussions by kathia

One of the richest resources to you as a ClearStation member is your fellow members. Our large, experienced community of investors participates actively in Member Discussions*. You can glean invaluable information about individual stocks, investment strategies, and other relevant topics on the boards. In the Discussions, you'll find not only lively, passionate debate about stocks but a group of investors—novice as well as seasoned—sharing their experiences, ideas, and knowledge. We highly recommend taking advantage of it!

Here are some tips for using the Discussions:

- Use the Discussions as a sounding board for investments you're considering. Take a look at what others are saying about the stock—see what kinds of recommendations people are making and why. If a stock has 3 recommendations to go long and 36 to short, you may want to research it a bit more before taking a long position in it.
- Before you take advice from someone, you may want to check out his/her Recommend List. To do that, just click on the person's username.
- If you have a question, by all means, ask it! If it's a general question for anyone to pick up, just add a post. If it's a question for a specific member or related to a specific post, click on the relevant post and then click on the "Reply" link. The member will be notified of your reply by email.
- Likewise, if someone replies to your post, you will be notified by email. **Do not reply to the email!** The response will go to ClearStation Support rather than the person it was intended for. Go back to the Discussion area and reply to the post there.
- Lastly, always be courteous in the Discussions. We don't take kindly to malevolent or rude posts. In fact, they can result in [loss of posting privileges or account deactivation](#).

* You can access the Discussions from any graph 3-Point View page (the link is on the action bar—at the top of the page just under the header).

Portfolio as a Learning Tool by kathia

Portfolio can be a useful learning tool.

As you read through the other Education articles, you'll discover investing methods and ideologies that you may not have applied to your own trades before. If you see one that piques your interest, use Portfolio to try it out!

ClearStation members can create an unlimited number of portfolios. A tracking portfolio is an excellent, risk-free way to test a new investing strategy. In your trial portfolio, pretend to buy and sell stocks only according to principles that you wish to test. See how you do over a period of time before you use the strategies in real life.

Yes, you could add these stocks to your Watch List—after all, Watch List was designed specifically for tracking stocks you are considering taking positions in. However, there are a few advantages to creating a tracking portfolio:

- The graph of any stock in your portfolios is annotated with a blue circle at the point you opened the position and a red one when you close. It's helpful at times to be able to see how your position is doing relative to the price action of the stock.
- You can keep track of positions over time in order to determine how you are doing.
- Closed positions are recorded so that you can go back and examine your successes as well as the bombs to see what worked for you and what you may have to rethink.
- If you have any questions about how to perform specific functions in Portfolio (add a stock, delete a stock, etc.) please take a look at our [Help area](#) for more details.

Finding Investment Ideas with Tag & Bag by kathia

One of the most useful tools on ClearStation, Tag & Bag consists of lists upon lists of stocks, screened and sorted according to a multitude of criteria—technical, fundamental, and community.

What's so special about Tag & Bag? It's a shortcut. It's a timesaving way of reviewing new investment ideas, sorted by category. If you like to buy stocks just prior to a split, for instance, Tag & Bag serves them up on a platter!

At first glance, T&B may not look "time-efficient." All those lists... so many stocks within each list... how does one find time to explore it?

That's the beauty of this area: it's grouped by category so you can go directly to the lists that interest you. Pre-sorted, pre-sifted, pre-chewed—that's Tag & Bag! Here are a few tips for optimizing your T&B usage:

- Determine which lists give you the best stock picks according to your investing style and concentrate on those. If you have extra time to kill you can always go back later and look at additional lists. For example, if you trade stocks that do high volume, use the "Most Actives" category; if you like stocks that are starting to trend, use "Today's Trending Issues." You get the picture.
- Lists can be sorted by any of the column headers that appear as links—just click on one.
- When viewing a list, use the "Graphs in Bulk" feature. It's a very powerful tool! It allows you to quickly scan hundreds of graphs at a time. By taking a quick look at a stock's graph, you can decide which stocks merit more in-depth research. When you find one, click on the stock's name to go to its 3-Point View page or simply add it to your Watch List to follow it more closely over a period of time.

The graphs will appear in the order that the list is sorted by. So if you sort the list alphabetically, the graphs will also be in alphabetical order.

"Graphs in Bulk" can be adjusted to your preferences by going to Customize (on the top line of the ClearStation nav bar). You can select the number of graphs you'd like to see per page as well as the size of the graphs and which indicators you'd like shown.

3-Point Investing: The Basics by kathia

How do you decide which stocks to invest in?

People have different ways of picking stocks and validating their investment decisions. Some people use fundamental analysis: news, market research, what analysts are saying, etc. Others use a more scientific approach—technical analysis. Then there are those who base their decisions on what they hear from their sphere of influence.

Are any of these methods wrong? Indeed not! However, if you combine all of these into a system of "checks and balances," you'll have a more powerful tool at your fingertips.

ClearStation breaks this all down into a **3-Point Investing Approach**.

The basic premise of 3-Point Investing is that there are three ways you can find stock picks: using technical analysis, using fundamental analysis, or by getting ideas from the community. Once you have your pick, the other two areas help validate and monitor the choice.

For example, let's say at dinner last night Uncle Vito told you about what he claimed to be the hot stock of the coming year. His excitement was contagious, so you decide to investigate this one further. This being a community pick (you got the idea from people around you), your next move is to check the stock's fundamental and technical information in order to determine whether it merits your time or is just another dog like the last five tips Uncle Vito gave you. If the stock looks promising, add it to your Watch List—this allows you to keep an eye on it for awhile to see how it performs.

Make sense?

Understanding Fundamental, Technical, and Community Analyses

by **kathia**

Is it clear what technical, fundamental, and community analyses are?

Technical analysis is a more scientific approach to determining a stock's health. To sum it up, it's using math in order to spot patterns and trends in the historical price action and using them to predict future price action. Simply put, it is reading and interpreting graphs: formula points are plotted on graphs, and by analyzing the information on the graph you can get an idea of how the price of a stock will move.

Technical analysis assumes that all the factors that influence a stock's health are built into the price. This includes earnings, management changes, investor activity, and so forth.

Fundamental analysis is broader in scope and more commonly used than technical analysis. Basically, it is using all available information to determine how good an investment a particular stock is. It involves looking at the company's earnings, reading up on recent news, and examining income statements, and the like.

Community analysis is simply getting ideas from your environment. It's including the views of those around you and taking their knowledge into consideration as a factor in your investment decisions.

Finding Stocks Using the 3-Point Approach by kathia

ClearStation provides you several ways to find investment ideas—here are a few to get you started:

Get ideas using technical analysis:

- From the A-List selections from your Focus page.
- From Tag & Bag lists pinpointed on technical information.
- By deciding that the graph on a stock looks really good.

Get ideas using fundamental analysis:

- From Tag & Bag lists focused on fundamental information.
- By reading interesting news on a stock.
- By researching the stock's earnings projections, analyst ratings, etc.

Get ideas using the community around you:

- From suggestions by other members in Recommend.
- By getting tips from other experienced and knowledgeable investors in the Member Discussions.

Evaluating Your Stock Ideas by kathia

Once you've found a stock that interests you, the next step is deciding whether or not it's going to make you money. If you used technical analysis to pick the stock, you would want to check the fundamentals surrounding that stock as well as what other people are saying. If you used fundamentals, you would want to study the technical indicators in addition to reading up on what people think. If you used a community recommendation, you would check the technical and fundamental information.

Most of your research can be done from a stock's graph 3-Point View page. This page is loaded with everything you need in order to make a sound decision.

Go to the stock's 3-Point View page (one way is to enter the stock's symbol in the Get Graphs! box at the very top of any ClearStation page).

- You'll see the graphs—they provide the basic data (price, volume, etc.) you need to determine if a stock is technically sound. If you don't understand how to read and use the graphs, never fear! Links next to the graphs direct you to the corresponding Education articles.

If you are comfortable with the basic indicators shown, or like to use other ones, you may click on the link for the Interactive Graph Tool (on the action bar at the top of the page) to build your own graphs. However, if you're new to technical analysis, we encourage you to get familiar with the basics before trying to conquer new territory.

- At the bottom of the page you'll see a list of all recent news items related to that stock. For more company and stock background, check out the action bar—you'll find links for Profile & Quote data and Analysts & Earnings information.
- Also on the action bar, you'll see the link for Member Discussions. This is where you'll find out what other ClearStation members are saying about the stock—whether they recommend going long or short and why.

The best way to get good at picking stocks is by practicing a lot! Use the 3-Point Investing method as a guideline, and find out which approaches work best with your investment strategy. Create a tracking portfolio using this method and see how you do. No system or approach can guarantee that you make money on your investment, but by taking advantage of all the resources available to you, you cut the risk involved enormously—and increase your chances of succeeding.

Monitoring Your Investment Ideas by kathia

Once you've decided a stock is worthy of your time and energy, there are two ways you can monitor it: add it to either your Watch List or one of your Portfolios.

If you are interested in only a quick view of the stock, add it to your Watch List. Watch List provides a "bare-bones" look at the stocks you are interested in. You get pertinent information in a quick, easy-to-view format.

However, if you'd like a more comprehensive look at the stock, create a tracking portfolio. With a portfolio, you get a more complete look at the performance of the stock over a period of time.

Once you've added the stock to your Watch List or Portfolio, your Focus page helps you monitor it. Focus lists how well the stock is doing as well as any fundamental or technical events affecting it. Let's say a stock you're tracking goes up 11 in one day: it not only gets listed in the "Doing Well" column but also in the Percentage Gainers category—and any other category that it may qualify for.



ClearStation Education: Reading Graphs

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Reading Graphs

Price Graph

Indicator Graph

The first thing you want to be able to do is read ClearStation graphs: you make your initial assessments of a stock based on what you see on these graphs. A firm understanding of these graphs is the first step toward solid investment choices using technical analysis. They offer important information - if you know what you're looking for!

In this section, you'll learn:

- How to read a **price graph**
- What **trending bars** are and how they work
- The basics on **MACD**, **MACD histogram**, and **stochastic** (more in-depth information will be provided in later chapters)

Price Graph Basics by kathia

Lucent Technologies Inc (LU)



ClearStation's graphs facilitate quick assessment by displaying important data clearly.

The top chart is the **price graph**. This graph charts a stock's price over time. The bars across the top of the price graph are trending bars (green for uptrends, red for downtrends). Generally, you want to go long stocks whose graphs show predominantly green bars and short (or avoid) stocks where red predominates.

- The price bars are usually drawn in red. The bottom of the price bar marks the low for that day, and the top indicates the high. On the right side of the bar, a tiny horizontal red dash marks the closing price. It's bullish if the closing price is near the high of the day, and bearish if the closing price is down toward the day's low.
- Every now and then you'll see a blue bar instead of a red one. A blue bar indicates that the stock reached a 52-week record price high that day.
- The 50-day exponential moving average (EMA) is drawn in purple. The 13-day EMA is drawn in green. These lines identify the overall direction of the price of a stock. **The most important thing to note is whether prices are above or below these two moving averages.** The "Moving Averages" section explains how to use this information when making a trade.

Trending Bar Basics by kathia

Edac Technologies Corp (EDAC)



The trending characteristics and capabilities of a stock are the most important pieces of information the price graph has to offer.

The green and red bars that trace across the top of the price graph describe the ability of that stock to move in a persistent vertical direction (up or down) over time. **A green bar suggests an uptrend (vertical movement up) and a red bar suggests a downtrend (vertical movement down).** You want to go long in stocks in which green predominates and avoid or short stocks in which red predominates. If neither color dominates (but rather, a candy cane effect with rapid switching from red to green), that suggests the inability of that stock to make sustained progress in either direction. Unless you are a short-term or day trader, you want to avoid stocks that exhibit this non-trending characteristic.

If you receive an anonymous tip for a stock whose graph is dominated by red bars, you want to hang up the phone. If green dominates, start taking notes!

We have gone to great lengths to map what MACD is saying on top of the price graph in order to provide the clearest, most unbiased assessment of whether a stock trends or does not trend. Trending is the first assessment to make when considering a stock for purchase.

Some stocks trend. Others do not. **It is far easier to make money in stocks that trend vs. stocks that do not trend.** If a stock trends, the bars will appear above prolonged periods of persistent price action in one direction.

Edac Technologies Corp trends. The bars are fairly well timed.

More on Trending Bars by kathia

ClearStation's software considers a number of different variables before determining that a stock deserves a trending bar on its price graph. Among the most important of these variables are EMAs and MACD. Of course, we also consider other factors: volume, general volatility, and history to name a few.

In other words, whether the bars appear isn't determined by just one indicator; a combination of events causes them to go up or down.

Crossovers are turning points for trends. Whenever a crossover happens, whether it's the EMAs or MACD, it's likely that a trending bar will be triggered. Here are some guidelines to keep in mind:

- When the 13-day EMA crosses over the 50-day EMA, that's a clear sign of an uptrend. The 50-day EMA crossing over the 13-day signals a downtrend.
- For MACD, determining whether the crossover is going to cause a trend is trickier. It really depends on where the crossover happens (as well as on what's going on with the other indicators). If the red fast line crosses over the blue slow signal at or above the centerline, you have a trend. But if the crossover happens below the centerline, you don't. A trend doesn't occur until the lines sail up past the centerline -- and then only if the other indicators are healthy.

Downtrends are just the flip side. The blue slow signal must cross over the red line below the centerline for it to really count.

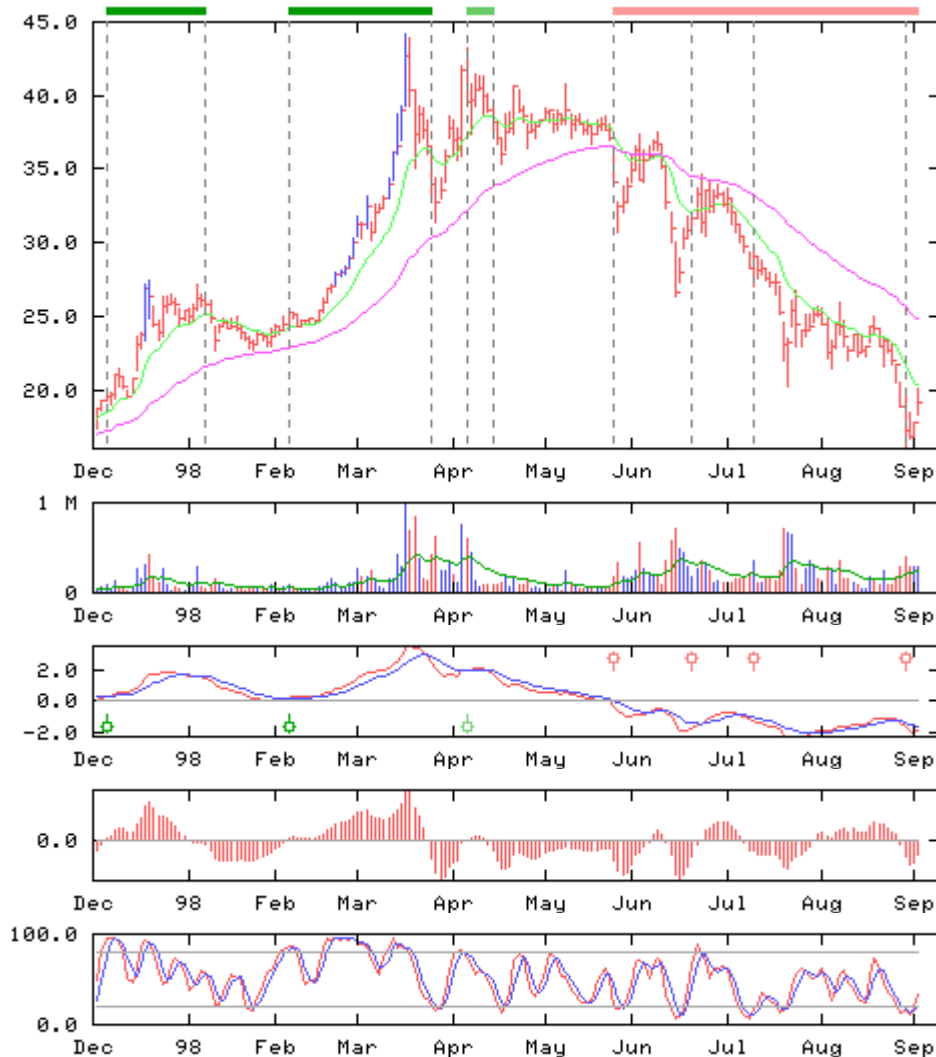
(Note: You'll learn more about MACD in upcoming articles. If you don't understand how it works now, you should by the time you read through Education.)

Any of the same factors can cause a trending bar to "go down". When a trending bar goes down, that trend is said to have "stopped out" or "paused".

Sometimes the end of the trending bar signals a definitive break in the trend. However, it could be pausing (or catching its breath) before starting another leg of a longer, ongoing trend.

Color Coded Assessment by kensey

Ballard Power Systems Inc (BLDPF)



Stock market players all over the world follow each uptick and downtick. They act independently, but a record price high means that a consensus has been reached on a particular stock.

On ClearStation graphs, 52-week price highs are drawn in blue, so you can get an instant assessment of each stock's ability to lead. There are many investors who only follow and consider for trade those stocks that have reached a 52-week price high. William O'Neill has made a career out of this.

Professional traders tend to fade (or short) record price highs if they appear to be of dubious merit. Most of us simply climb on board. The important thing to watch when a stock reaches a record price high is whether or not there will be follow-through. BLDPF was not able to follow through after hitting a 52-week price in December, yet it was able to do extraordinary things after it hit a 52-week price in February.

What to do?

ClearStation offers lists that provide the opportunity to evaluate and consider stocks for trade before the 52-week price arrives. Stocks will most likely already be in MACD green when price highs hit (this was true in both cases for BLDPF). While it is not a definite rule, it is true more often than not.

So, 52-week price highs often arrive late. The guard dog has already barked. As such, 52-week price highs are continuation events. They confirm the trend that is already in place. Actually, one of my initial motivations to build ClearStation was that I was tiring of having stocks pop onto my radar screen only after a price high had been reached. I'd look back and say, "Wow, this stock has been in an uptrend for over a month."

If you try to time your purchases with an eye toward the trend bars drawn on top in green vs. price bars drawn in blue, you will be in a much better position to take advantage of a stock's trend. Rarely does a 52-week price high mark the beginning of a trend.

Promising Looking 52-Week Price High: COST by kensley

Costco Companies Inc (COST)



Costco hit a 52-week price high on Friday (May 29th). This is illustrated on the price graph by the blue price bar. How is this event to be evaluated?

First, look at some of the other interesting events that are occurring here. At the same time the record price high was hit, a green trending bar appeared on the top of the price graph to signal the start of a new leg of Costco's ongoing bull trend. There is also a very impressive stack of blue bars on the volume graph. A blue bar on the volume graph means that the stock went up that day. Had it gone down, a red bar would have been drawn. The volume we are seeing here is similar to the hardcore buying that occurred in late February. Market conditions were a bit more favorable back then, and this fact is the one caveat that must be kept in mind.

So the price high is interpreted here as a true bullish event. The important ducks seem to be lined up: a green trending bar, big volume, a crossover of the MACD lines at the centerline, and (of course) the record price high.

Accumulation seems to be in order. Pay heed to the fact that the current price is quite elevated over the 13-day EMA. Stocks have a tendency to trace back and touch the 13-day EMA after a strong run up. So you will want to back in slowly. If, in fact, Costco opens lower next Monday (Lord knows what the market's gonna do next week), 55 dollars is the ideal price level to start picking up shares. If there is a serious rollover in the markets on Monday, then it's fodder for the Watch List.

MACD: Not Just a Burger by kathia

The first thing to check out when you're interested in a stock is the trending bars above the price graphs. Why? Because you make money by riding out stocks that are trending.

But after getting an initial impression of which direction a stock is trending you should **always** study the MACD (Moving Average Convergence-Divergence) graph.

The MACD graph (third graph from the top) has a fast line (the red one) and a slow signal (the blue line). **The crossing of the red line over the blue can denote the beginning of a trend.** The uptrend typically stops when the blue line crosses above the red.

Where the crossover happens tells you whether there is a trend and how strong it is. When the red fast line crosses over the blue line at or above the centerline (which serves as a constant at a zero value), the stock is trending hard - a definite candidate for a long position! The higher above the centerline it crosses, the stronger the uptrend is. If the crossover occurs below the centerline, the uptrend indicated is not nearly as strong

America Online Inc (AOL)



Let's take a look at AOL. This stock has been in an uptrend for months. Pretty evident from the price graph, don't you think?

Check out the green bars over the price graph. Now look at the MACD graph (third graph from the top). See how, each time the red line crosses over the blue, a green bar is born over the price graph? See how the price goes steadily up when this happens? (The green bar disappears when blue prevails over red.)

Did you notice where the centerline on the MACD graph (0.0) is in relation to the crossovers? Each time the two lines cross higher above the centerline, the uptrend gain more momentum, and the price rises with more intensity.

To stress it again, the easiest way to make money is by latching onto a stock like AOL that is trending big time. In six months you could have doubled your investment. **That** is the power of MACD.

On the Downside by kathia

Microlog Corporation (MLOG)



Microlog has been downtrending for a while. My first clue was the red bars over the price graph, but I don't rely solely on these. Don't get me wrong - they give you the heads up on what kind of position you might take, but I personally like a little more reassurance. Call me cautious.

After checking out the MACD bars over the price graph, I always examine the MACD graph (third from the top). The graph provides a more in-depth look at how strong the trend is. I keep an eye on a stock that is trending; I take action when a stock is trending hard.

Downtrends occur when the blue line crosses over the red. (Well, not always... It also depends on where the crossover takes place. When the blue line rears its ugly head and bypasses the red line above the centerline, a downtrend doesn't get signaled until the lines drift below the centerline.)

The centerline plays an important role in determining how strong a downtrend is. If a crossover takes place **below** the centerline, that's a fairly good indication that the stock is indeed in a downtrend. The farther it crosses below the centerline, the better! (If, of course, you are shorting that stock.)

The Fast and the Slow by kathia

Understanding MACD boils down to one thing: being able to understand the relationship between its two lines, the fast line (in red) and the slow signal (in blue).

Each line is an exponential moving average.

- The fast line results from the difference between the long- and short-term moving averages. To be more precise, the 26-day EMA of the closing price (the long-term moving average) subtracted from the 12-day EMA of the closing price (the short-term) gives you the calculation for the fast line.
- The slow signal is a moving average of the fast line. You derive the slow signal by calculating the 9-day EMA of the fast line.

Just by watching how these two lines interact, you can glean vast amounts of information about a stock. The two most important things to watch are the meeting and crossing over of the lines and where in relationship to the centerline they cross.

Crossovers and the Centerline

Crossovers can signify trends. For example, the red line crossing and rising above the blue line could signal the start of an uptrend. Likewise, the blue line crossing over the red could be the start of a downtrend. What determines whether the crossover is strong enough to signal a trend is where it happens. That's what really counts.

The centerline is the key! Where a crossover happens in relation to the centerline can offer a strong indication of where that stock is headed.

- When the red fast line crosses over the blue slow signal above the centerline, that is a good indication of a bullish trend. The higher above the centerline the lines cross, the stronger the trend acts.
- When the blue line crosses over the red above the centerline, it does not necessarily mean that there is a big downtrend looming in the distance. It can also signify a pause in the current uptrend. The stock could be taking a breather before it lifts off again.

This happens often. Some graphs to study are AOL, C, and CSCO.

- If the red line crosses over the blue line below the centerline, it can mean that the downtrend is stopping out (or pausing), or it could be that things are turning around and the stock is heading for an uptrend. However, because the crossover happened below the centerline, the trend probably won't be too strong. In cases like that, the graph doesn't get marked with a green trending bar until the lines have moved up over the centerline -- and then only if the other indicators are positive as well.
- The blue line crossing over the red below the centerline is a good sign of the beginning of a downtrend. Keep in mind that the farther below the centerline the crossover takes place, the stronger the trend!

The Histogram in Brief by kathia

The MACD Histogram (second from the bottom) is used in conjunction with the MACD graph. When the fast line on the MACD graph (the red one) is sailing over the signal line (the blue), the bars on the Histogram are drawn above its centerline. When the blue line is over the red, the bars are below the centerline.

The slope of the bars gives you a better idea of how strong a trend is: as a trend gains momentum, the bars grow progressively longer. As it slows down, the bars get shorter and shorter.

Chrysler Corp (C)



The beauty of the Histogram is that it signals reversals in trends. Sometimes signals can be deceiving; you may think a stock is doing really well when in reality it's going to take a nose-dive.

What to look out for:

- When a stock breaks a record price high but the Histogram is responding limply in tiny bars, bad sign! Sell. Basically, it means that though at the moment the bulls are showing off their strength, the bears are really in control of the situation. A good example of this is Chrysler. Take a look at the graph - specifically mid-April. There's a MACD green bar over the price graph, and it hit record price highs, but the MACD Histogram is only exhibiting small bars. Watch how the price action went during that MACD green period -- the price just kept falling.
- When a stock hits a record low and the Histogram is lurking below the centerline, it's a good idea to consider buying that stock.

When the Timer Goes Off by kathia

Making a decision about what kind of position to take on a stock is much like cooking a roast.

For the roast to be cooked perfectly, all the conditions have to be just right. A pan that it will fit in, a hot oven, a timer so you don't overcook--they all work together to produce a succulent meal. If the oven is too hot or the timer isn't set properly, you might be stuck with a hunk of charred meat.

Stocks work the same way. All the conditions, or indicators, need to be used in sync for the best results. When you use the indicators in conjunction with each other, the chances that you'll make a more profitable decision increase.

If MACD is the hot oven, then stochastic is the timer. Stochastic follows the short-term movements of the stock and gives you an idea of when to take action.



Stochastic (the bottom graph) is shown by two lines (red and blue) fluctuating between 0 and 100. At the 20 and 80 marks, there are horizontal gray lines.

When the red and blue lines dip together under the 20 line, it means the stock is oversold (everyone is selling). When the lines float together above the 80 mark, the stock is overbought (everyone and his/her mother is buying).

So what does it all mean? Provided the other indicators are healthy, you want to buy when a stock is oversold because the short-term prices are likely to rise. Sell when a stock is overbought, and short-term prices are likely to fall!

How is stochastic handy? In late March, do you see how stochastic was indicating that the stock was overbought? Both the red and blue line are sailing over the 80 mark. The wise option would have been to wait until early April when the lines fell below the 20 mark (meaning the stock was oversold) to buy. If you look at the price graph again, you'll notice that at that point the price had fallen a bit right before it was about to coast up again.

A word of caution: stochastic is an indicator of **short-term** activity! It shows you when a stock's price is oscillating (moving up and down in a range) rather than trending (moving in one direction continuously). Be careful not to base long-term actions on it.



**ClearStation Education:
Interactive Graph Tool**

Version 1.0
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Introduction

ClearStation's Interactive Graph Tool is a powerful, flexible means of evaluating stocks' technical health and comparing stocks and indices. With the IGT, you can choose among nine technical indicators to help you choose and time your trades. This article is a primer on the indicators ClearStation covers; if you're interested in learning more about any of these indicators, there's a resource list at the end of the article.

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Interactive Graph Tool

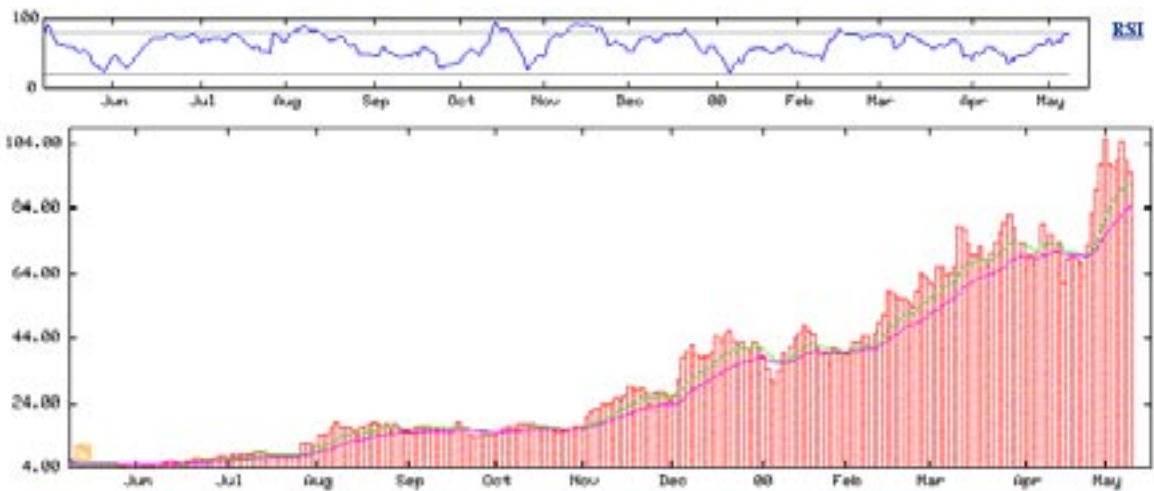
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Relative Strength Index (RSI)

Relative Strength Index (RSI) Most indicators measure a stock's performance by comparing it to that of another stock or index. The Relative Strength Indicator (RSI) is an oscillator that measures a security's price relative to itself and its past performance, thereby indicating its internal strength. This tool is best used in conjunction with the daily price graph. If you compare the downtrend and uptrend of the RSI and price graph below, you will see consistent movement starting in November. As the market became more active, the RSI trending line and the fluctuations in the price graph became more consistent.

RSI is able to quantify price momentum because of its sole dependence on the changes in closing prices. This indicator is less affected by sharp rises or drops in a security's daily price performance and may therefore give a better trend reading than other indicators (much in the way the Williams%R measures the strength of bulls and bears).

RSI is calculated by taking the average of the closing prices of the up days and dividing them by the average of the closing prices of the down days. The time frame specified determines the volatility of the indicator (see formula below). For instance, a 9-day time period under study will be more volatile than a 21-day time span. The RSI ranges between 0 and 100. RSI is said to indicate an "overbought" condition when it is above 80 and an "oversold" condition when it is below 20. However, the buy and sell level varies depending on the number of days used in the calculation. A shorter span of days will result in a more volatile indicator which reaches further extremes. A greater number of days used in the calculation results in a less volatile reading which reaches extremes far less often.



RSI Formula:

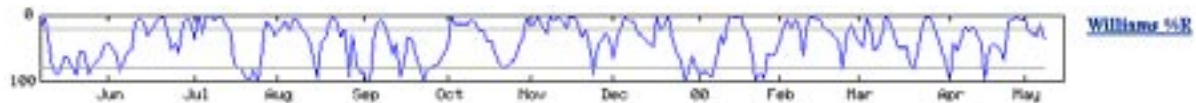
$RS = (\text{average of the net of positive closing prices for 7 days on ClearStation}) \div (\text{average of the net of negative closing prices for 7 days on ClearStation})$

Williams %R

Williams %R The Williams %R is a momentum indicator that attempts to measure overbought (bearish) and oversold (bullish) levels--or exit and entry points--by measuring an index or stock's closing price in relation to its high-low price range for the day. Wm%R is closely related to the Stochastic; both are oscillators that effectively measure over-bought and over-sold points in volatile markets that are also trending.

Although the Wm%R indicator looks like its oversold and overbought numbers are placed on the wrong ends of the oscillator, it was designed to be read this way. When this indicator reaches levels of 80-100, it suggests the security is oversold, and readings in the 0-20 range signal overbought conditions. On the graph, 0 represents the peak of the bulls' power and 100 represents the peak of the bears' power.

Bulls may push prices higher during the day, or bears may push them lower. Wm%R shows which group is capable of closing the market in its favor. If bulls cannot close the market near the top during a rally, they are weaker than they seem; this is seen as a shorting opportunity. If bears cannot close the market near lows during a decline, they are weaker than they appear; this is seen as a buying opportunity. This indicator is most often used to take advantage of a stock's short-term price dips and spikes.



Williams%R Formula:

$$\text{Wm\%R} = 100 \times (\text{times}) \frac{\text{Hr} - \text{C}}{\text{Hr} - \text{Lr}}$$

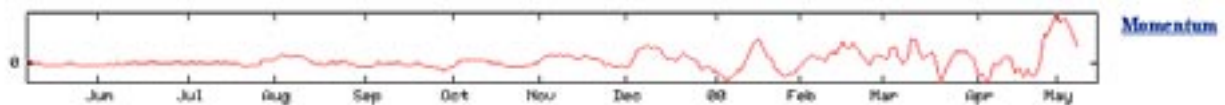
r = the time window selected (7 days on ClearStation)
Hr = the highest high during a 7-day period
Lr = the lowest low in a 7-day period
C = the last close.

Momentum

The Momentum indicator measures the amount that a security's price has changed over a given time span. This display is based on a simple numerical table that compares a stock's closing prices for the last 7 days. In theory, a stock's closing price accurately represents its movement. If the red line is flat, then the indicator is showing 0 momentum and the stock is in a "sleepy market"; any changes in its closing price will affect the stock's momentum. This indicator is most effective in a trending and volatile market.

If used correctly, this indicator provides sell signals. The method of using the Momentum indicator as a leading indicator assumes that market tops are typically identified by a rapid price increase and market bottoms end with price declines. As the market peaks, the Momentum indicator will climb sharply (dramatic movements of this nature typically identify the trading intensity associated with the end of a trend) and then fall off, diverging from the continued upward or sideways movement of the price.

Similarly, at a market bottom, the Momentum indicator will drop sharply and then begin to climb well ahead of prices. The seasoned investor will watch the closing prices inch higher before the stock's momentum propels it into larger price movements. This indicator is most effective when used with Bollinger Bands, because both indicators supply early buy signals.



Momentum Formula:

$M = \text{Momentum } P(\text{today}) = \text{today's closing price}$

$P(\text{today} - N) = \text{closing price of } N \text{ days ago (chosen by trader)}$

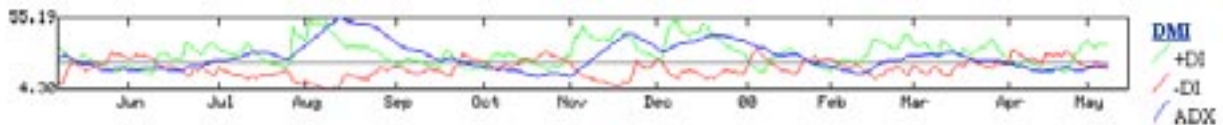
Directional Movement Index

"Directional Movement is the most fascinating concept I have studied. Defining it is like chasing the end of a rainbow."

- J. Welles Wilder

It's important to understand that Directional Movement must be either up or down for one day - it cannot be both. DMI helps provide an indication of how strong the directional movement (trend) is in a stock. It is comprised of three components; the first is the ADX, which rates the directional movement (trend) of a stock on a scale of 0-100. Generally, the higher the number, the more a stock is trending and the more it is a candidate for a trend following system. The next two components help decipher what the trend is showing: DMI + is a measure of upward or positive movement in a stock, and DMI - is a measure of negative or downward movement in a stock. A buy signal is given when DMI + crosses DMI - and a sell signal is given when DMI - crosses over DMI +.

The ADX line is used to measure the strength of these signals. When the market is exhibiting minimal direction, the ADX tends to decline. As the ADX points down it's better not to use the indicator and to wait while the market consolidates. "When the ADX falls below both Directional lines, it identifies a flat, sleepy market. Do not use a trend- following system, but start getting ready, because major trends develop from such lulls" (Elder, Trading For a Living).



Calculating +DI and -DI

+DI = +DM (divided by) TR (True Range)

-DI = -DM (divided by) TR (True Range)

True Range is always a positive number. There are three options:

- A. The distance from today's high to today's low
- B. The distance from today's high to yesterday's close
- C. The distance from today's low to yesterday's close.

The highest of the three becomes the default number used for True Range.

Directional Movement (DM): equals the largest part of today's range outside of yesterday's range.

- A. If today's range extends above yesterday's range, Directional Movement is positive (+DM)
- B. If today's range extends below yesterday's range, Directional Movement is negative (-DM)
- C. If today's range is inside yesterday's range or extends above and below it by equal amounts, there is no Directional Movement (DM = 0).

If today's range extends both above and below yesterday's range, DM is positive or negative, depending on which side of the "outside range" is larger.

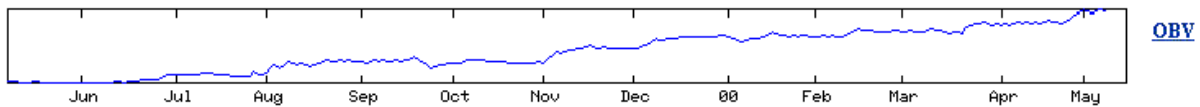
On Balance Volume

"Reading trends accurately involves more art than science, but most technicians believe you must always pay special attention to the average daily volume of trading in your stocks. No market move means anything without volume because the market is essentially a big consensus engine."

- Jon Markman, Online Investing).

On Balance Volume (OBV) is a momentum indicator that relates volume (consensus) to price change. Typically, before the price of a stock goes up, the volume increases. OBV is effective when combined with Bollinger Bands and the price graph, because they together provide early signals that a stock is preparing to break out of a consolidation period along with the confirmation presented by the price graph.

This indicator is a running total of volume calculated by adding the day's volume to a cumulative total when the price closes up, and subtracting the day's volume when the security's price closes down. It shows if volume is flowing into or out of a security. When the security closes higher than the previous close, all of the day's volume is considered "up" volume. When the security closes lower than the previous close, all of the day's volume is considered "down" volume and is subtracted from the OBV. If prices close unchanged, the OBV is unchanged.



OBV Formula:

On Balance Volume is calculated by adding the day's volume to a cumulative total when the security's price closes up, and subtracting the day's volume when the security's price closes down.

If today's close is greater than yesterday's close, then: $OBV = \text{yesterday's OBV} + \text{today's volume}$

If today's close is less than yesterday's close, then: $OBV = \text{yesterday's OBV} - \text{today's volume}$

If today's close is equal to yesterday's close, then: $OBV = \text{yesterday's OBV}$

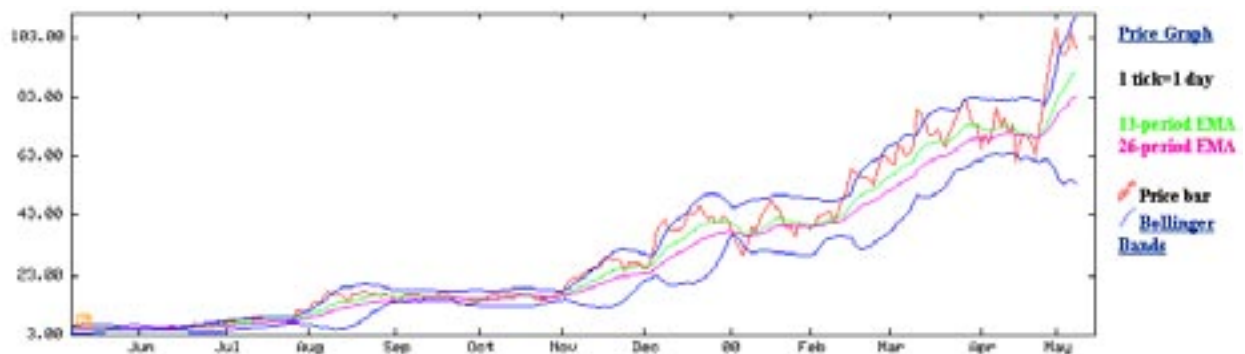
Bollinger Bands

Bollinger Bands, created by John Bollinger, are a type of envelope (or trading band) plotted at standard deviation levels above and below a moving average. Because standard deviation measures volatility, the bands widen during volatile markets and contract during calmer periods.

In Achelis' *Technical Analysis from A to Z* (Chicago: Irwin, 1995), Bollinger has this to say about his indicator:

- Sharp price changes tend to occur after the bands tighten, after volatility lessens.
- When prices move outside the bands, a continuation of the current trend is implied.
- Bottoms and tops made outside the bands followed by bottoms and tops made inside the bands call for reversals in the trend.
- A move that originates at one band tends to go all the way to the other band. This observation is useful when projecting price targets. (p. 72)

Bollinger Bands, displayed in two bands plotted at standard deviation levels above and below a moving average, provide a view of the current trading range. They can be used with other indicators to determine when to buy or sell.



Bollinger Band Formula:

$$\text{Middle Band} = \frac{\sum_{j=1}^n \text{Close}_j}{n}$$

The upper band is the same as the middle band, but it is shifted up by the number of standard deviations (e.g., two deviations). In this next formula, "D" is the number of standard deviations.

$$\text{Upper Band} = \text{Middle Band} + \left[D * \sqrt{\frac{\sum_{j=1}^n (\text{Close}_j - \text{Middle Band})^2}{n}} \right]$$

The lower band is the moving average shifted down by the same number of standard deviations (i.e., "D").

$$\text{Lower Band} = \text{Middle Band} - \left[D * \sqrt{\frac{\sum_{j=1}^n (\text{Close}_j - \text{Middle Band})^2}{n}} \right]$$

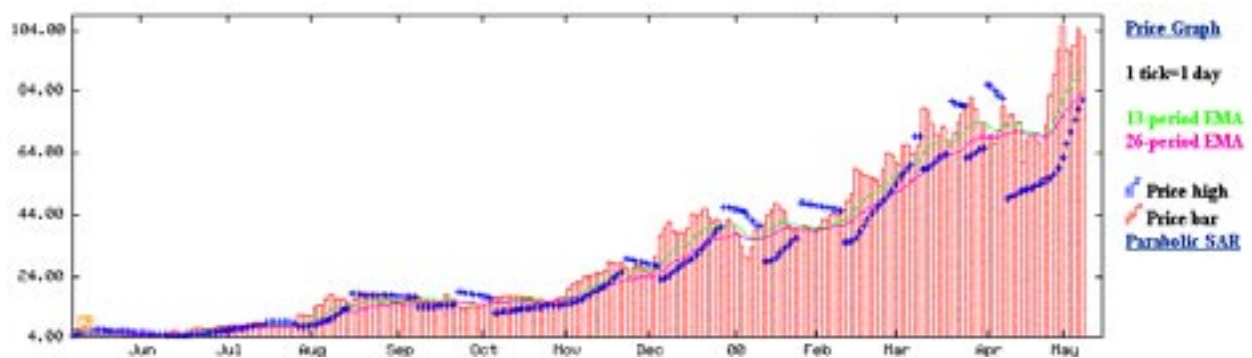
Parabolic SAR

The Parabolic Time/Price System, developed by Welles Wilder, is used to set price stops and is usually referred to as the stop-and-reversal (SAR) indicator. Once a trade is initiated using Parabolic SAR, a protective stop order has also been initiated. The stop is a function both of price and of time. The stop never backs up; it moves only incrementally on a daily basis in the direction the trade was initiated. This ties into one very good rule: "move your stops only in the direction of the trade and never against it" (Elder, *Trading For a Living*).

Some technical analysts believe that the Parabolic SAR provides excellent exit points. They use this indicator to close long positions when the price falls below the SAR and close short positions when the price rises above the SAR. Indecision is reduced using this indicator because it doesn't allow investors to stay in losing positions.

The Parabolic SAR is most effective when the markets are trending; when the markets are flat, Parabolic SAR is susceptible to being whipsawed, a clear sign that the timing is wrong.

This concept is explained in Wilder's book *New Concepts in Technical Trading Systems* (Trend Research, 1978).





ClearStation Education: Trending

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Trending

MACD

MACD Histogram

Volume

Moving Averages

A trend occurs when the price of a stock continues to rise or fall over a period of time. In an uptrend, each high is higher than it was the day before. And in a downtrend, each low is lower than the last.

ClearStation stresses the importance of trending. The tendency to trend is the key observation to make on a stock you are considering for investment. Why? Because it's easier to make money on a stock that is moving in a certain direction rather than going with one that is flapping up and down like a beached fish.

Not all stocks trend. By being able to identify those that do, we feel you will be more successful in your investing.

In this section, you'll learn:

- The merits of following a **trend**
- How to read a **MACD** graph
- To be wary of **volatility**
- How to use the **MACD histogram**
- What **volume** signifies
- How to use **moving averages**

Trending by kensey

The price action of a stock is categorized as either trending (moving generally up or down) or range-bound (sideways). Trending stocks are going somewhere in a vertical direction, while range-bound stocks travel horizontally.

A trend exists when prices keep rising or falling over time. This is called directional price action. In an uptrend, each rally (upsurge) penetrates a higher price level than the prior rally, and each retracement (fall) stops above the level associated with the prior retracement. It's like a set of stairs at an angle.

MACD helps identify whether or not a stock trends. We feel it is far easier to make money by investing in stocks that trend versus stocks that do not trend.

ClearStation maps MACD action onto the top of the price graph so that a stock's trending tendency is readily apparent. Uptrends are suggested by green bars while downtrends are represented by red bars. While we don't purport to have built an automated trading system, we think the bars will help you identify which stocks exhibit good characteristics of trendability. If the bars above the price graph are well timed, that stock trends. If the bars above the price graph are ill timed, that stock does not trend. By avoiding stocks that do not exhibit the tendency to trend, you will be more successful in your investing.

America Online Inc (AOL)



What's the big deal about trending?

It's far easier to make money in stocks that trend than in stocks that only fluctuate up and down.

The **first assessment** you should make of a stock is whether it's trending. A stock in an uptrend has a MACD indicator graph (the third graph from the top) where the centerline (0.0) is pushed down towards the bottom, or a MACD indicator graph where the centerline doesn't even exist (the bottom of the indicator graph *is* the centerline). It's in "positive ground."

The magnitude does not matter that much. What matters more is where the 0.0 line sits. Is it in the middle (a crapshoot)? Is it towards the top (downtrend) or is it at the bottom (uptrend)?

Take a look at the MACD graph for AOL. Do you see how the centerline is pushed to the bottom and how the red and blue lines soar above it? It's signaling an uptrend. Now look at the price graph and see how the soaring prices of the stock are echoing what the MACD graph was telling you. If you had picked up on AOL's uptrend when the latest MACD green trending bar was born (in early June), you would have made a timely entry into the stock and done well.

Needless to say, trending is the way to go!

Healthy Crossover by kensey

Mindspring Enterprises Inc (MSPG)



A MACD crossover occurs when the red line crosses over the blue line on the indicator graph.

Take a look at the strong crossover of the MACD signaling lines that occurred in mid-June.

This event is marked by the little green up-arrow on the MACD indicator graph. The arrow corresponds to the start of the green bar over the price graph. When this happens to a stock, it's said to have "gone MACD green."

What makes the MACD crossover that occurs in mid-July a "nice divergence?" For one thing, the crossover occurred **above the centerline**. This is most important, because it shows that this stock is in good shape from the get-go and not coming off a steep sell off.

Here's a tip: Get into the habit of eyeballing the MACD lines before you look at the price graph, and try to envision what the price graph is going to look like. This will help you interpret what this indicator means.

To Trend or Not to Trend by kensey

The strongest MACD crossovers occur near the centerline.

MACD Crossovers near the centerline usually herald the start of a new upward trend. Crossovers that occur higher above the centerline tend to indicate the continuation of an existing trend. It's all about center, and where the crossover occurs.

Unisys Corp (UIS)



This stock has been trending up so consistently that, until recently, the MACD indicator graph (3rd from the bottom) was entirely in positive ground. So, in this case, the bottom of the indicator graph *is* the centerline. This only occurs for the strongest stocks.

That said, the crossovers that occurred in mid-April and mid-June are the best ones on the graph. The fast line crosses over the signal line right **at the centerline**. The important thing now is to do a little pattern matching.

Both of the crossovers in mid-April and mid-June occurred after benign basing periods in which prices changed little. These basing periods are captured underneath the trendlines drawn in black.

The crossover in mid-March (that resulted in a green MACD trending bar) occurred higher above center. The crossover in mid-July is also occurring high above center. The reason for the July trending bar is the momentary dip in prices in early July. Even though the trending bar was taken down, it did not signal an end to the uptrend, but rather that the trend was pausing and the rate of acceleration in prices was slowing. For the trend to end, the MACD lines must penetrate the centerline and start tracing below it in negative ground.

How MACD Works by kensey

There is no substitute for looking at graphs and pattern matching in your brain. In fact, everything you need to know can be learned by looking at a lot of graphs. And the MACD graph is one of the most informative!

MACD represents the interaction of two moving averages. The long-term moving average is 26 days, the short-term is 12 days. When prices accelerate from either a trough (which is a drastic price decline) or a retracement (a more healthy movement sideways which doesn't violate that basic rules of uptrend), the shorter-term moving average overtakes the longer term one, crosses over it, and moves beyond.

The difference between the long-term and short-term moving average is the fast line, drawn in red. The MACD Histogram gives you a way to determine its strength. A smoothing (or rate of change) of this line is the slow line (drawn in blue).

When the fast line crosses above the slow line, prices are diverging and accelerating on the upside. Divergence simply means a significant change in behavior.

When a crossover occurs, it's examined to see whether it occurs above or below the centerline. Crossovers below the centerline are ignored. A stock is deemed weak if the gravity of the retracement (or trough) is serious enough to pull the MACD lines below center. Strong stocks stay above center for years at a time. Those that get hit hard enough to pull the lines below center are therefore deemed not worthy of consideration.

So, crossovers below center are ambiguous.

What happens when a crossover occurs below center? It is not ignored completely. The crossover could have occurred just a touch below center, and one more day might carry it forward enough to "go positive." Once things go positive, a signal is raised. This is not a strong signal. Crossovers that originate below center must be taken with a grain of salt. But currently, we are not throwing them out.

Again, look at the graphs. If a stock's where the MACD lines are below center and you can see declines in the price graph, it is clearly time to look elsewhere.

Crossovers above center are flagged if the rate of divergence (between the fast and slow lines) is significant. This gives birth to a green bar.

Timing is everything. Ignore price action at your peril. What you should get out of the green and red striping is a clue to whether you should wait, or whether it's time to jump. Urgency, or worrying about missing out should never have to enter the equation. That's the goal.

When the fast line crosses below the slow line, prices are diverging on the downside. This can cause a red trending bar to be born. The exception is if this cross below occurs above the centerline. This usually indicates that a trend is either pausing or simply slowing down.

Cross-below that occur below center cause a red bar to immediately be raised. This mirrors birthing of green bars on crossovers above center.

A cross-below that occurs above center is noted. The signaler then waits to see if the progression takes the MACD lines below the centerline, or whether a rapid breakdown in prices occurs. If either event occurs, a red bar is raised. This mirrors action on the cross-above side of the equation.

So, treatment in the bullish case (cross above) and the bearish case (cross below) is symmetrical. There are many heuristics thrown in (the signaler gets more aggressive on stocks with a demonstrated tendency towards either strength or weakness). The signaler also starts to shut down for stocks that gyrate meaninglessly across a horizontal plane. But that is generally how things work, so you should be able to start making sense of why red and green bars appear above the price graph.

Where Did the Green Go? by kensey

Time Warner Inc (Holding Co) (TWX)



Is it time to bail out of a stock when a bullish green bar is pulled down? Not necessarily. The MACD green trending bar that was born in early March was pulled down in late March. This happened because the fast line crossed below the signal line due to the momentary dip in prices in late March. This was not a serious dip. Prices were able to stay above the 13-day moving average which is a sure sign of short-term health. In fact, after forming a cup shape ("cupping") on the 13-day EMA for a few days, the rally in prices continued.

What happened here? The rate of increase in prices in TWX from mid-February through March was remarkably constant. If the rate of increase in prices is constant, any divergence will trigger a change of condition one way or the other. A momentary dip will cause the fast line to cross beneath the slow line and the trending bar will be taken down.

When the MACD green trend bar was taken down in late March, an interesting thing happened. Prices kept rising throughout April and May, but the MACD lines on the indicator graph gradually declined.

The reason for this phenomenon is that the rate of change in the upward acceleration in prices slows considerably. Prices are still going up, but not as fast. Once the rate of increase in prices slows, the longer term moving average (26-day) starts to catch up to the shorter term EMA (9-day). Therefore, the difference between these two moving averages decreases. Hence, the decline in the MACD lines.

If you eyeball the 13-day and 50-day EMA lines on the price graph, you can see that on April 1 (or thereabout), the purple line (which represents the 50-day EMA) starts to close in on the light green line (which represents the 13-day EMA). MACD uses moving averages of different lengths than these, but the effect is the same.

So, when a bullish MACD green bar stops it doesn't mean that you should bail. It does mean that it's time to start paying closer attention. You don't want to get shaken out during normal retracement action.

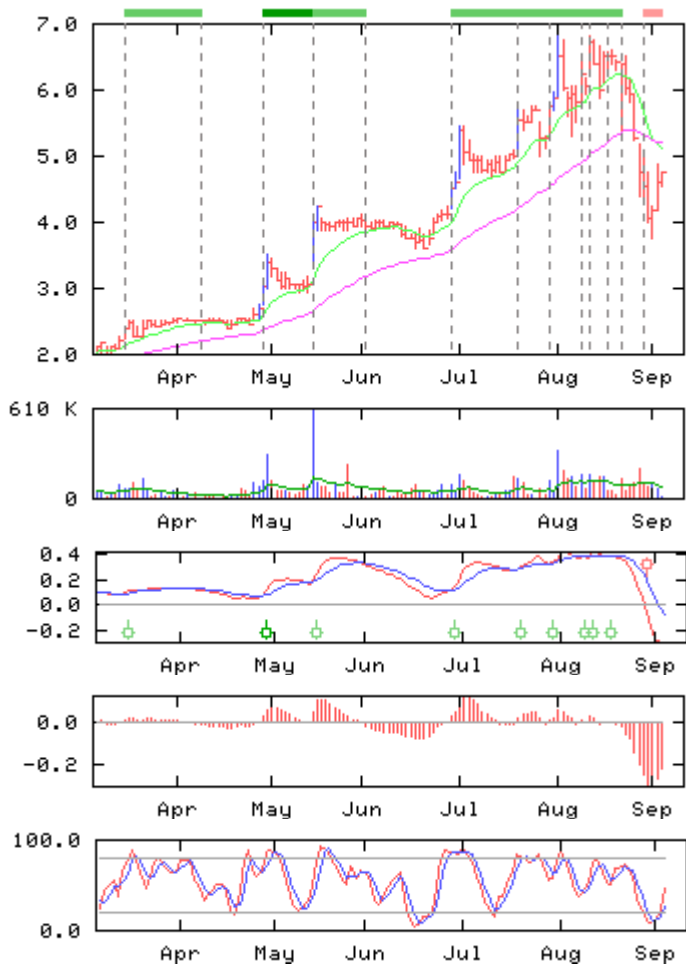
Normal and healthy retracement action will stop a bullish green bar, but that doesn't mean you have to exit a position, only to see prices resume rising after you get out.

I usually wait for the MACD lines to dip below the centerline before getting completely out. The end of a MACD green bar might be a good time to lighten the load and take some profits, but it doesn't necessarily call for dumping out of your entire position.

Many stocks stay above center for years. You want to hold onto those.

Volatility by kathia

Hansen Natural Corporation (HANS)



What's up with those funky spiked circles on the MACD graph?

When you see a "spiked circle", it indicates that a trend has started. The green marks at the bottom of the MACD graph represent uptrends while the red ones at the top denote downtrends. (They correspond with the trending bars on top of the price graphs.)

Trends are good, but when you see lots of the trending flags in a row it is not a positive sign. In fact, it's exactly the opposite.

Let's take a look at HANS. Fluctuations in the closing prices caused the MACD fast line (red) to bounce off of the signal line (blue). Each time the red line went down, crossed, and jumped back up over the blue line a new green flag was raised. Over a period of a month (mid-July to mid-August), five flags were generated.

The fact that so many signals went off should give you some important insights. The succession of flags is clueing you into the volatility of the stock. It's acting erratically, and that is not a desirable trait. In this case, it was a fairly evident sign of an ensuing fall in the price.

There is no telling what a volatile stock will do. Stocks that have fairly well timed signals and act more predictably offer better potential results.

More Green Than Red by kensey

Microlog Corporation (MLOG)



If you spend a lot of time looking at ClearStation graphs, you will soon notice that there are more bullish green bars drawn on the tops of graphs than red bars. The reason for this is that a bearish red bar is born only when there is a crossover of the MACD lines below center. This does not happen as frequently as do bullish crossovers above center. This is partly due to the fact that a lot of individual stocks right now are in fact above center.

I just ran a query that told me that 7102 stocks have MACD lines above center, and 5183 have MACD lines below center. This tells me that there are more stocks right now that have an upward bias.

MLOG has obviously been in a long-term downtrend as evidenced by red bars being drawn on the price graph. You can see that the red bars start whenever there is a crossover of lines which occurs below center. The crossovers that occur closer to the center are better signals. The crossovers that occur towards the bottom of the price graph are confirmations that lower prices are on the way.

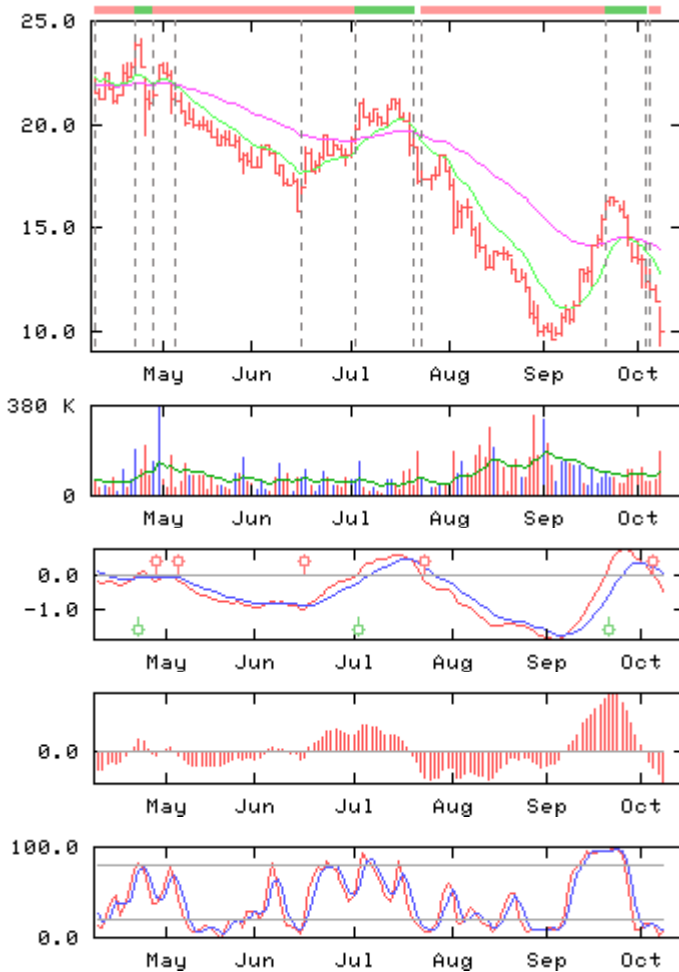
If you eyeball the stochastic indicator graph, you can see that whenever this stock gets overbought (which happens when the stochastic lines cross above the upper reference line), it's a pretty good sell signal.

Another reason that there are not as many red bars as green, is that lately it has been common for stocks to correct in short staccato bursts. We all know that retracements in the markets these days happen faster and deeper and are shorter-lived. Then the bull trend resumes. Certainly, you'd be hard pressed to find a red bar over a major market index.

I look more to stochastic for candidate stocks to short. Stochastic does a better job of locating stocks that are moving higher in the short term, but within the context of a longer-term downtrend. In this case, the fact that stochastic crossed the upper reference line in mid-April was a strong sell signal.

Ill-timed Green Bars during a Downtrend: PTEL by kensey

Powertel Inc (PTEL)



When evaluating the trending bars above a price graph, the color that dominates is the color that counts. When red dominates, give less weight to the green bars. When green dominates, give less weight to the red bars.

Powertel went into two eight-week downtrends that stretched two longish red bars across the top of the price graph. When stocks trend down, prices bounce and short-lived rallies ensue. Inevitably, existing shareholders sitting on paper losses try to make it back by buying again at a cheaper price. This is called dollar loss averaging. Alternatively, shorts that are sitting on gains head to the cashier stand.

Only add to your holdings ("pyramid") upon winning positions. Do take profits. The seller is doing the right thing, the buyer is doing the wrong thing. Notice that volume during both of the short lived rallies that produced green bars was thin. This does not indicate a strong trend up.

The short-lived rallies within the graph's six-month downtrend will sometimes persist long enough for a green trending bar to be traced on top of the price graph. These have got to be taken with a grain of salt. They are usually not buying opportunities. You have to side with the color that predominates and, if it is red, pass on a long trade

I like the green bar that traced in July a bit better than the bar that traced in September. The July MACD green bar came off relatively low volatility and prices were able to cross the 50-day EMA (that's the purple line).

Alas, with so many stocks out there, it makes more sense to look for opportunity stocks where green dominates the price graph.

Another obvious sign of weakness is that the MACD centerline is near the top of the MACD indicator graph. The MACD lines cross above the centerline in slow moving waves, but these look like the tips of mountaintops, without the persistent bulk that sits underneath.

Another obvious sign of weakness is that the 13-day EMA is more often than not below the 50-day EMA. This means the stock has shown consistent short-term weakness.

Cementation of the MACD Lines, Part 1 by kensey

Pacificare Health Sys Inc CI B (PHSYB)



When there is absolutely no change in price, MACD gets a little less useful and signals with a bit of a knee jerk; it tends to react emotionally rather than wisely.

In the case of Pacificare Health Systems, prices are increasing constantly, at a rate of approximately 1/4 point each day.

Constant change is reflected in MACD as the cementing of the lines which then trace horizontally across that indicator graph. The level at which the lines cement is indicative of the health at that level. It's more of a phenomenon, or something you can dissect in a lab than something you can trade by, but if you are vested when cementing occurs, you have a nice easy ride ahead of you.

Cementing is often accompanied by diminishing volume. This is not a bearish occurrence. It simply means that existing holders of stock are not finding any reason to sell, and there is not enough news or change in the fundamental outlook in the company to attract new blood.

This makes sense as volume in quantity often carries a bias that would push the stock in one direction or another. As it stands, an existing bias that was established earlier is carrying through to sustain the movement forward.

MACD will be extremely reactive to this situation. A change in prices the least bit down will cause an existing MACD green trending bar to be taken down, and any increase in prices above the seemingly built-in flat rate of increase will cause a new green bar to be born. But owing to the dynamic that is causing cementing to occur in the first place, prices will navigate back to the state (of normalcy) where the constant rate of change applies, and the trending bar will appear, in retrospect, to be ill-timed.

The reason I am pointing this out is that understanding this aids in a better understanding of MACD. MACD is good at pointing out divergences in prices. This means it will tell you when a stock that is in a downtrend is starting to turn around and begin an uptrend. MACD is therefore good at identifying points at which turns are being made, but not great when the road is straight ahead.

Cementation of the MACD Lines, Part 2 by kensey

Global Marine (GLM)



Global Marine has been perpetually weak since the red bar appeared in mid May. During this time, prices have persisted below the 13-day EMA and the stochastic lines have been extremely depressed. This is what a downtrend is all about. The reason you don't see more of this kind of stuff is that downtrends are usually short and vicious in nature. Long, steady declines are not as common as one would think.

The reason relates to the dynamics of the driller group. These dynamics change very slowly and then persist. Yet everyone thinks that things are about to turn, so the selling is not a cattle rush towards the gate. Actually, it's been my experience that slow rate declines are more bankable, and drastic declines (not price shocks or gaps that cut a stock in half) are more likely to turn around sooner.

The MACD lines cemented below the centerline in mid June. This means a constant rate of change down. The pace is approximately 1/4 point each day. You can see by eyeballing the 13-day and 50-day EMA's that they are traveling at approximately equal distances apart. Since MACD is derived from the difference between the 12- and 26-day EMA, the equidistant thing between these two happened sooner.

Note that, ever since the MACD lines cemented and flat-lined, volume has diminished. This is typical.

Depth and Dimension by kensey

The MACD Histogram gives depth and dimension to what the MACD lines are telling you.

The MACD Histogram measures the difference between the MACD fast line (in red) and the MACD signal line (in blue). If the fast line is above the signal line, the MACD Histogram is positive, and the bars are drawn above the centerline. If the fast line is below the signal line, MACD Histogram is negative, and the bars are drawn below the centerline.

Chrysler Corp (C)



The MACD Histogram indicator graph is the second from the bottom. The MACD indicator graph is right above that one. The two are used in conjunction with one another.

Do you see that smallish hump above the centerline on Chrysler's MACD Histogram indicator graph that occurs in mid-April? That's a bearish development. Why? Because the hump is smaller than the preceding hump above the centerline, **yet** prices are higher. In other words, there is a divergence between the events on the price graph and the Histogram. On the price graph we are seeing new highs, yet on the MACD Histogram, quite a small hump is being traced.

Does this mean that mid-April's short green bar is bogus? Not entirely. The green bar was born when there was quite a bit of up volume, as indicated in blue on the Volume graph (which in this case was treacherously deceiving). You simply can't be sure what is going to happen next when dealing with the right edge of any graph, and the bullish green bar above the price graph does terminate correctly after the retracement begins.

When MACD Histogram starts to tick down right after a bullish green bar is born, that's the time to watch carefully and get ready to bail. It means that a new leg on an uptrend might be failing.

Maxing Against the Ceiling by kensey

What does it mean to say that a stock is "maxing against the ceiling?" It means that it is doing so well that the bars on the MACD Histogram indicator graph are hitting the top. It means unequivocally that new highs in the MACD Histogram confirm the upward direction in that stock's prices.

When you see this happening, you know right away that it's a very good thing.

Vari-L Company Inc (VARL)



The hump being traced by the MACD Histogram beginning in mid-April is against the top of the MACD indicator graph (the second from the bottom). This confirms the record price highs that are occurring on the price graph. Record highs on the price graph are drawn in blue. Blue is good. I also like the way blue dominates the bars on the Volume graph. Good stuff.

Even though the bars of MACD Histogram have dropped somewhat below the ceiling, things still look bullish. Why? Because maxing against the ceiling foretells that bullish action on the way.

Constant Rate of Change by kensey

Dow Jones 30 Industrials (_INDU)



Throughout March, and for most of April, the rate of increase in the DOW was so constant that MACD Histogram doesn't really tell you anything meaningful. The uptrend underneath the bullish green bar is so linear that the moving averages used to derive MACD are essentially moving in lockstep. There is simply not much of a notable divergence in prices.

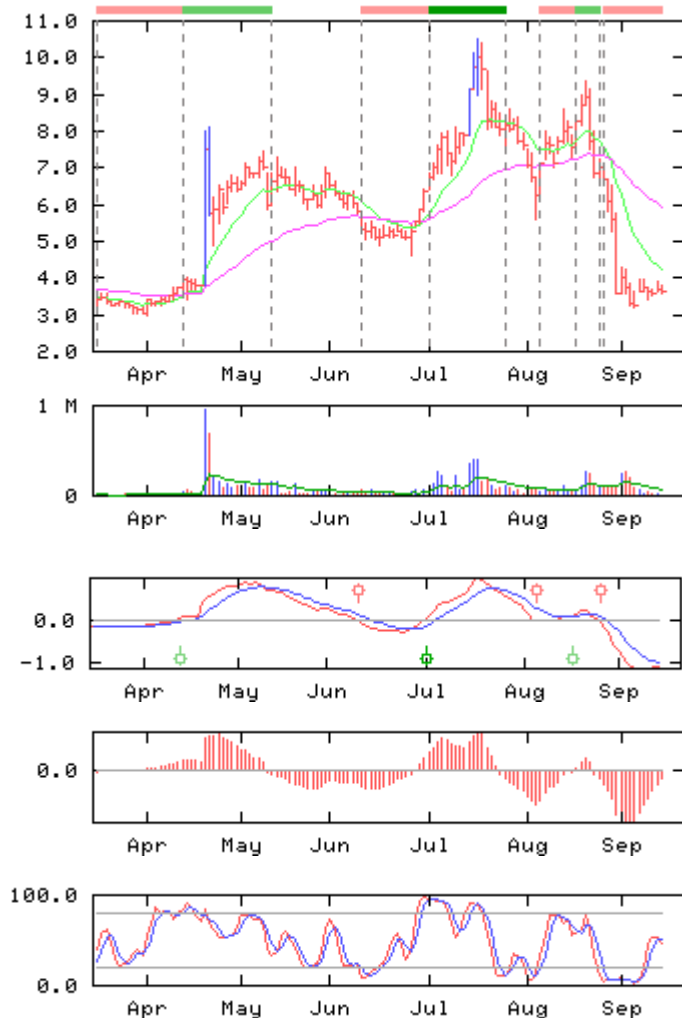
MACD is best used to detect price divergences. It's most informative when prices are changing direction. Once that change of direction is consummated, the subsequent crossovers in the same direction (bullish in this case) are not as informative.

MACD Histogram hits the ceiling in February. It starts tracing down, approaches the centerline, and proceeds to wobble. The humps in March and early April are negligible.

As you can see, MACD Histogram had big things to say in February. It shouted out from a megaphone. But once the uptrend got underway, there really wasn't much else left to say.

Dealing with Ill-timed MACD Bars by kensey

Image Entertainment (DISK)



In mid-August, volatile price action in Image Entertainment (DISK) sent out a green MACD trending bar that was ill timed. It would have led to a poor trading decision on the long side if it were interpreted in a bullish light without considering a few caveats.

The tip-off that something was amiss was the big increase in volatility. Prices fell from the mid-July peak of 11 dollars per share down to 6 dollars a share in a little over two weeks.

The red trending bar that then started to trace in early August was very ill timed as it appeared at the absolute low of this downward price break. Bars that are this ill-timed bespeak oscillation and not trending. Volatility also picked up significantly. If you eyeball the dark green bar of early July, you'll see that it was born in a period of very low volatility. The price bars in early July are very tight and the price action did not include a lot of intraday swings. This contrasts sharply to the picture we have of this stock in mid-August.

This illustrates a fairly common pattern of price action in smaller cap issues. The first wave up starts on low volatility and decent volume. Volume picks up and drives the move forward. Finally, the stock plummets (and the green trending bar is yanked down). Volatility increases as prices drop steeply. In such a steep price drop, it is best to stand aside as price action becomes unpredictable and classical technical analysis techniques become less useful. In this case, a price spike up caused a green trending bar to be born.

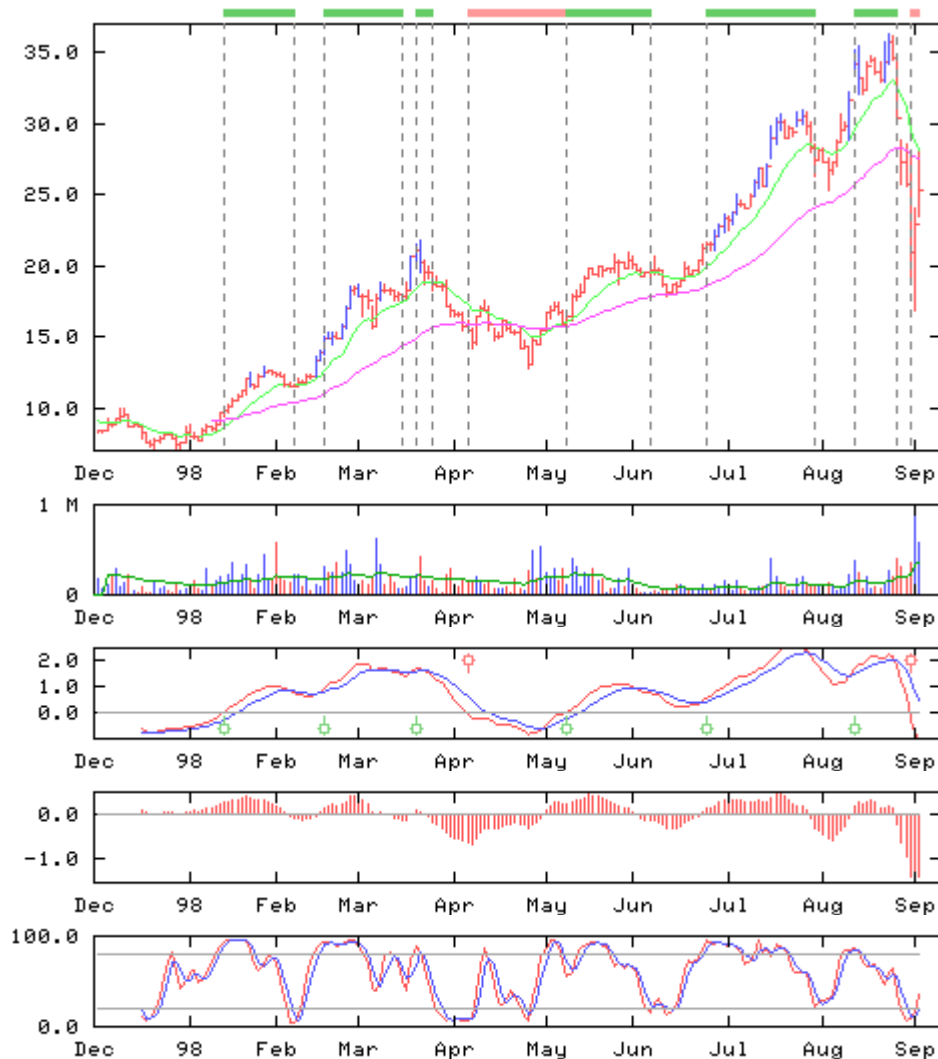
Unstable price action is volatility. Stable price action is trending. The middle ground is oscillation (where profits can still be had, but they are harder to come by). But volatility should be strenuously avoided when you see it.

Volume: Color Coding and Instant Assessment by kensey

Each bar in the volume graph (second from the top) is drawn in one of two colors. Blue is used if a stock's price went up that day, and red is used if the price went down.

This allows quick recognition of whether buyers or sellers are controlling a stock.

Metromedia Fiber Network Inc A (MFNX)



The dominant group moving the stock of MFNX is definitively buyers. The blue volume bars predominate, and stack much higher than the red. This says that when the stock rises, it is being propelled by a much larger crowd of investors.

An important observation to make here is that once the frenetic buying slowed between the run-up in January and mid-March, sellers did not unload stock in a serious way. Most of those who got in during the doubling of the stock apparently have held onto it. Yes, the stock underwent a fairly stiff retracement, but the volume under which it occurred was relatively low and unconvincing. This is made clear by the fact that there are no significant bars drawn in red in the March and April period.

Which brings us to May. Now that the basing period is over, MFNX is entering a very nice uptrend that suggests it may pierce its previously set 52-week high. Volume has picked up considerably as evidenced by the blue bars, and the price bars are nice and tight. Tight price bars indicate a gradual uptrend in which all participants are thinking along similar lines, and it's a conversation that is proceeding with apparent ease.

Avoid volatility. Look for tight price bars accompanied by big volume. Uptrends that persist usually start out on low volatility. If you look back at the January period, it was not volatile. The pickup in volatility that happened in March hinted that a retracement was just around the corner.

Got the Blues? by kensey

Arterial Vascular Engineering (AVEI)



The late April volume that drove AVEI dropped to a price level where the support line was heavy and did some damage. This period of selling is represented as a relatively high stack of red bars on the volume graph.

Then, in early May, AVEI started to rally. But note that the corresponding stack of blue bars is shorter than the red bars that piled up when this stock was on its way down. This suggests that this reflex rally is relatively weak in nature; it's occurring on lower volume.

When this reflex rally within a bear trend dies out and the selling returns, it will be important to note whether volume once again increases. Stocks that get hit this hard usually retest their lows. This means that prices will probably dip back down to the support line.

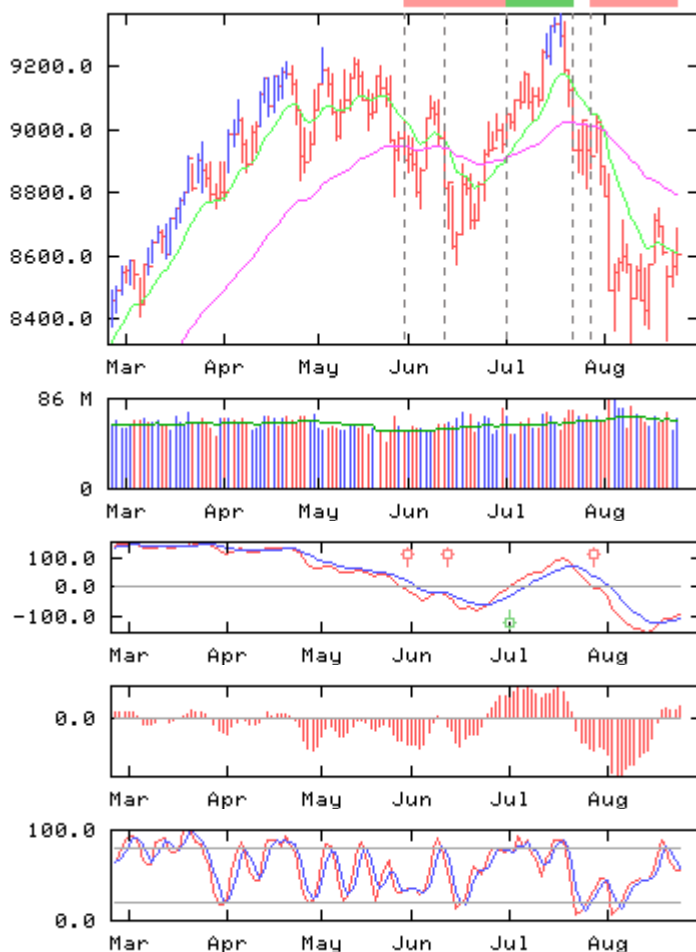
Remember that if the red volume bars stack higher than the preceding blue volume bars it means that Arterial has a shot of breaking through support and it could be a short hop down to 25. (You can tell that my inclination here is to be bearish!)

But, if the retest of support is on weak volume, Arterial would likely bounce off the support line and head toward recovery. Note that the weakness of the MACD lines suggests that there's a long road ahead for this stock.

In any case, this assessment will be possible due to clear color coding. Its relative height is most important. If the blues stack higher, that's bullish. If the reds stack higher, that's bearish.

It Rallies Tomorrow, Right? by kensey

Dow Jones 30 Industrials (_INDU)



An analysis of the early May 1998 volume going into the stocks that compose the Dow 30 suggests that the second leg down was weaker than the one that preceded it. This is sort of hard to see, but the 'leg down' is the drop that began on May 1.

If you look at the relative height of the volume bars, the stack of red bars is not only smaller than the blue stack immediately before it, but shorter still than the red stack that first brought the DOW below its 13-day exponential moving average (drawn in green) for the first time in three months.

So there was less of a punch in the selling than there was last time around. (Good - the market did rally from this point, but it did not get that far.)

Of course, puncturing a moving average that has stood up for three months is kind of ominous. But the volume pattern suggests that not a lot of money is exiting the markets right now (still referring to when this article was first written - May 7).

OK. Let's provide an update - June 1, 1998. The most significant characteristic of the DOW right now is that it looks poised to roll over. If you look at the other market averages on the Diary page, the DOW would be the last one to go (if it does). If the DOW doesn't roll over, then all of this is just a washout of the small caps (the Russell 2000 on the Diary page looks AWFUL) and the DOW is holding. (Go team!)

The fact that the DOW holding up is bullish in my opinion and it's why I currently have a smattering of DOW stocks on my recommend list. I'm probably the only guy in the world who thinks this divergence is bullish, but until the DOW rolls over, I think the crowd that holds DOW stocks (they are conservative, yes?) is holding course. And it means that fund managers are rotating money out of small caps and into big caps. So it's still being put to work.

The strength of the dollar versus the yen is one negative to keep an eye on. This will kick big cap profits in the teeth. If the DOW pierces 140 yen to the dollar - much later - it's going to rain (even though it's summer). But the inflation outlook is the best it's ever been (up one percent over the past year) and the bond market has been strong. These are two very favorable conditions.

What has me scared, though, is the possibility of the 13-day EMA crossing below the 50-day EMA. Again, from the Market Diary page, you can see what kind of carnage was wrought when the EMA's crossed on the Russel T, then on the Nasdaq Composite and both OEX's.

Anyway, the way I'm playing it is to be short technology and Internet stocks, and long a handful of 'special situations' and some DOW stocks. Long where there is strength, and short where there is weakness (though my DELL short didn't bring any cheers from the Motley Fool crowd). As time moves on, my short list is growing and my long list is shrinking proportionately.

Moving Averages: A Definition by kensey

ClearStation uses 13-day and 50-day exponential moving averages (EMA). These are fairly standard values. The 13-day EMA is drawn in light green, and the 50-day EMA is drawn in pink.

Avid Technology (AVID)



To define an exponential moving average (EMA), it will be helpful first to define a simple moving average (MA). A simple moving average shows the average price over the last n days:

$$\text{Simple MA} = (P_1 + P_2 + \dots + P_n) / n$$

where P = price

The problem is that simple moving averages are "jumpy." They respond twice to each piece of data - once when it is added, and again when it drops off. Having the moving average change when a price is removed is a bad thing. When a high price is dropped, the MA will most likely tick down. When a low price is dropped, the MA would probably tick up even if the price went up that day, but by an amount smaller than the value that was dropped. As Elder says, "A simple moving average is like a guard dog that barks twice."

The solution to the unreliability of this alarm is to use Exponential Moving Averages.

An exponential moving average gives more weight to the latest data and responds faster to changes than does a simple MA. At the same time, EMA does not jump in response to old data being dropped off. Again, as Elder says, "This guard dog has better ears, and it only barks once when someone approaches the house."

$$\text{EMA} = \text{price today} * K + \text{EMA yest} * (1 - K)$$

$$\text{where } K = 2 / (N+1)$$

This is a continuous formula: Each day the latest price is factored in, and old data fades towards oblivion, as it should. The older the data, the less importance is attached to it.

Moving averages are useful in that they act as floors when prices are rising. You see how the price graph of AVID hugs the 13-day EMA the whole way up? If a price bar of AVID breaks through the 13-day EMA convincingly, this would suggest that continuation of the uptrend is somewhat in doubt.

Acting as a Floor Under Prices: ABT by kensey

Abbott Labs (ABT)



Moving averages are useful because they typically act as floors below prices when they are rising, and as ceilings above prices when they are falling.

The price graph of Abbott Labs illustrates these characteristics. During the MACD green uptrend that occurred between mid-January and early March, the 13-day exponential moving averages served as a formidable support line below which prices did not significantly penetrate.

Once the price bars pierced the 13-day exponential moving average in late March, it signaled the arrival of a relatively stiff retracement. During this retracement, which lasted throughout April, the 13-day exponential moving average served as a formidable resistance level, which prices did not penetrate at all.

In mid-June, a new MACD green bar was initiated and prices rose once again above the 13-day exponential moving average. As such, this seemed to be the optimal price level at which to try to pick up the stock (if you were so inclined).

When Not to Chase a Stock by kensey

When a stock is in a strong uptrend, it's easy to fall into the trap of picking it up when it is up a couple of points, before a dip that could provide a better buying opportunity.

Using the 13-day EMA (the green line on the price graph), you can establish a price the stock is likely to gravitate back to, and as a result, determine a more favorable time to buy in.

Cisco Sys Inc (CSCO)



CSCO has hugged the 13-day EMA tightly during its recent uptrend. Each time it breaks away from that level, the stock seems to navigate its way back. Sellers come in at each staccato burst and take profits in a fairly predictable way.

Eyeball the 13-day EMA, and use that to ballpark the price. You can wait for the stock to fade back to this level, and once it does, schedule your buy order to fire off along with everyone else's.

As I write this in early June, the stock has broken out and closed right at the high of the day. This is a very bullish development indeed.

The 13-day EMA is at approximately 76 dollars a share. I would buy now. There will probably be some follow through tomorrow, but given CSCO's affinity for coming back and touching the 13-day EMA, I would seize this opportunity and place my order.

Acting as a Floor Under Prices: IBM by kensey

Intl Business Machines Corp (IBM)



IBM has been in a very strong uptrend, despite the market's relative waffling overall.

As I pen this (May 22), the stock is sitting right on the 13-day EMA, (the green line on the price graph), having come back down to this level in a linear fashion. Interestingly, this occurred after a huge day that brought the stock to a 52-week price high.

It's amazing how often this occurs. A stock has a huge day on big volume, cracks a 52-week price high and appears to be off to the races. Instead, a retracement the next day brings it back to the 13-day EMA, and traders are standing around in the pit scratching their heads in disbelief.

Given the strength that IBM has exhibited in the recent past, I'd look to buy the stock.

However, if IBM cracks and closes beneath the 13-day EMA, this would be a sign of technical weakness, and I would exit immediately. Were I to trade tomorrow, my game plan would be "if it's up, buy it."

But if it instead falls back and cuts below the 13-day EMA, I'd close out, get some sunshine, and golf it up. That's my win-win scenario.

Gravity and EMA 13: TRBD by kensey

Turbodyne Technologies Inc (TRBD)



This stock had an incredible break out in early July 1998, accompanied by all the good things: volume, a gap, and a real throw-caution-to-the-winds attitude. Such success could make you want to start your own company.

After the breakout, things subsided and gravitated back to the 13-day EMA. The 13-day EMA acts like reality - no matter how heady things become, it beckons and throws cold water on a stock, no matter what the situation.

It pays to wait for the 13-day EMA. Once prices kiss this line, it's time to back up the truck. There is never a need to chase a stock. You can eyeball the price level of the 13-day EMA and know where your entry point is going to be. Especially after a huge runup like this on a fairly obscure and thinly traded stock. If you just can't wait, then nibble. But don't over do it. Leave yourself in a position to react positively to a retracement.

Acting as a Ceiling Over Prices: CYBX by kensey

Cyberonics Inc (CYBX)



Ever since CYBX went out of MACD green in mid-April, the stock's price has slid 70 percent. This decline has been so linear that the stock never even went into MACD red - the lines never crossed over again after the top. However, this situation will soon be remedied.

The 13-day EMA was barely touched the whole way down. What this tells you is that until a stock crosses back above the 13-day EMA, there is no reason not to hold course (if you were shorting the stock, that is).

So beware when a stock you own drops below its 13-day EMA! If it's a small cap like CYBX, your risk goes up. When holding untested and volatile small caps, or extremely over-valued Internet stocks, it pays to err on the side of caution, and sell.

Once you've dumped out of a losing stock or a stock that's experienced a loss, forget about it. ClearStation will provide you with ample candidates to choose from. Direct your attention elsewhere.

Later on, go back and look at the losing trade to see what went wrong. By this time, it will be a rewarding experience as the stock will probably be below where it was when you got out. And even if it is higher, who cares? The reason for closing it out was a good one.

An Amazing Floor Under the Price: GMGC by kensey

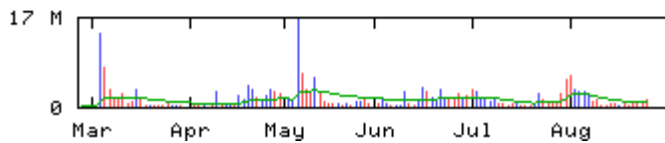
General Magic (GMGC)

June 15, 1998

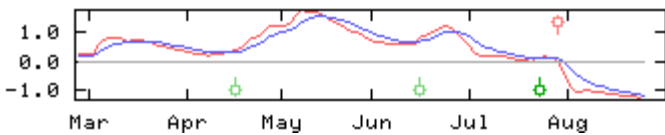


General Magic has technology everyone wants - voice recognition.

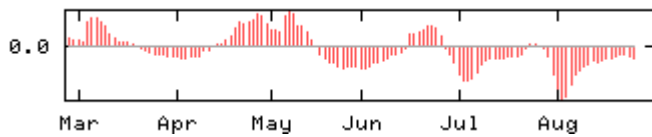
General Magic traded for under a buck a share at the beginning of the year, and closed today at around 12 dollars a share. Is this the lomega of 1998? Quite possibly. Since tripling in price in one day on March 1 (from 2 dollars a share to approximately 6), GMGC has hugged the 13-day moving average like it can't get enough of its love. It is **the** defining characteristic of its uptrend.



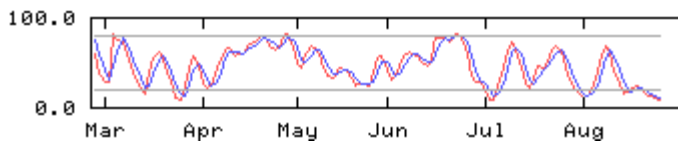
Especially bullish about the hugging and clinging going on here between GMGC prices and GMGC 13-day EMA is that it forms a well-rounded cup. This means that as GMGC was basing in the beginning of May, and coming back to the reality of the 13-day EMA, it maintained its upward bias. In other words, the base had an upward bias to it.



Rounded cups are a phenomena unto themselves, but when one coincides with 13-day EMA hugging, the case is bolstered.



Now (June 15), GMGC is starting to lift off the 13-day EMA. This offers a chance for others to get a nice hug. An incredibly smooth hump below the centerline of MACD Histogram bespeaks the gradual grace and lack of volatility of GMGC trade during this recent basing period. The MACD lines should cross tomorrow if there is any follow through on today's bullish action. With any luck, the similarity in MACD from mid-March to mid-April period will match what is happening now in the mid-May through mid-June period, with the hope that the mid-June to early-July period will offer gain similar to the mid-April to early May period.





ClearStation Education: Oscillating

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Oscillating

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Oscillating Stochastic

Oscillators determine the short-term movement of a stock. They identify turning points when you may want to buy or sell a stock.

Using an oscillator can be tricky. There are a number of caveats to heed. But once you understand them, the trading world opens wide before you.

In this section, you'll learn:

- What **stochastic** is and how to read its signals

Stochastic: The Basics by kensey

Stochastic is an oscillator. An oscillator compares the current price of a stock to its trading range in the recent past. It tells us if the current price is unsustainable and about to turn around and head in the other direction.

Stochastic helps identify turning points as prices swing back and forth within the scope of the more significant trend identified by MACD. Stochastic can be used to time trades effectively, but it needs to be used in conjunction with MACD. If MACD indicates an uptrend, stochastic can be used to time trades in the direction of that trend (up). If MACD indicates a downtrend, stochastic can be used to time trades in the direction of that trend (down). You don't want to trade opposite the direction of the broader trend!

Cisco Sys Inc (CSCO)



You can see the essential behavioral attributes of stochastic and MACD in the indicator graphs of CSCO.

The green bars on the top of the price graph indicate that CSCO is in an uptrend. Green means GO: you want to look for timely opportunities to buy the stock.

In mid-April, stochastic dipped below the bottom reference line. This means that CSCO was trading at a lower price compared to the range of prices in the recent past. CSCO was oversold. If you were looking to buy the stock, this was a good opportunity.

The more shallow retracement in late April was also a nice opportunity to trade into CSCO. Stochastic did not quite hit the bottom reference line, but it still indicated short-term weakness in the price of the stock.

When you are convinced of a trend's integrity, buying on pullbacks makes sense. Stochastic helps you identify these opportunities.

Oversold in an Uptrend: AOL by kensey



Even in wildly bullish markets, short-term, panicky waves of selling occur.

Stochastic tells you when that short-term sell-off has reached an unsustainable level of pessimism and prices are about to resume moving in line with the longer-term trend. That is how the professionals make money: betting against short-term extremes in favor of a return to normalcy, which is the more persistent trend identified by MACD.

After a steep sell-off in November, AOL went into a solid uptrend. The starting point is marked by the green MACD bar that started in early December.

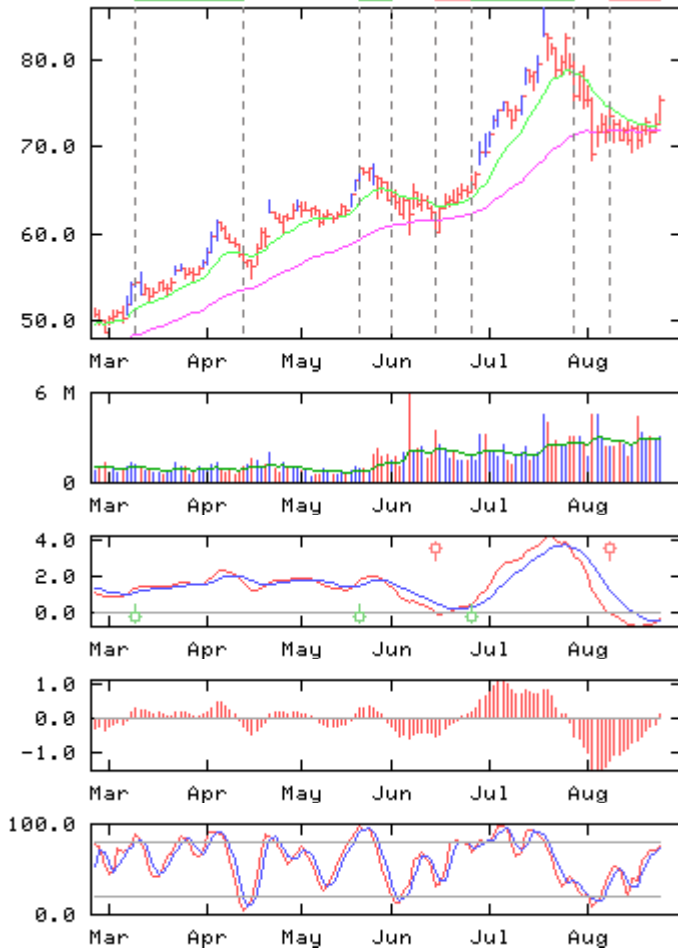
Now, stochastic gives us a number of excellent opportunities at which to establish a position. The first was in late January. The next occurred in early March and the last in late

In all of these instances, stochastic touched the lower reference line. This means the stock was short-term oversold. However, with MACD green and solidly above center these were opportunities to get into a very strong uptrend.

Buying into a stock that is short-term oversold but in a longer-term uptrend is an excellent way to use stochastic.

Oversold in an Uptrend: WLA by kensey

Warner Lambert Co (WLA)



It's important to identify the difference between stochastic and MACD.

MACD is a trending indicator. It tells us at a general level whether a stock is in an uptrend or a downtrend. This is the first assessment you should make on a stock. If it's trending up, you want to be long. If it's trending down, you want to be short.

Stochastic indicates short-term fluctuation. It displays the short-term movement of a stock.

So MACD tells you whether you want to be long or short, and stochastic helps you pinpoint opportunities to trade in the direction of that trend.

When WLA (which has been in a strong uptrend for most of its adult life) crossed below the bottom reference line on the stochastic indicator graph in mid-April, it became short-term oversold.

Remember this simple rule:

Long-term Uptrend
 + Short-term Oversold

 Good Buying Opportunity!

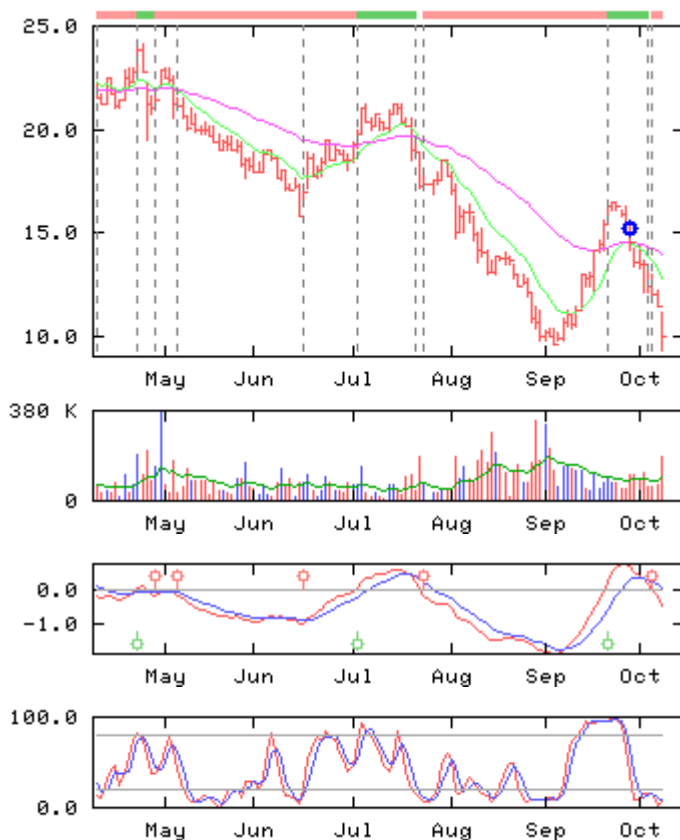
The beauty of this strategy is that as emotion grips the market in short-term bursts of buying and selling, opportunities present themselves to "get in" or "get out," in line with the longer-term trend that has demonstrated persistence and staying power. Simply put, this strategy affords you the advantage of trading in the direction of the long-term trend and against the direction of the short-term reaction.

The oversold condition on stochastic in early June looks to have been a bad signal. One tip-off was the heavy selling leading in to the oversold condition. Investors bailed out in droves right as the MACD green trending bar appeared (which also appears to have been a bad signal). This happens.

Now, a pitched battle is going on as WLA struggles to hold above its 50-day EMA. There have been increases both in volume and volatility. It is best to wait these things out. Increases in volume and volatility are typical ways even the best of trends comes to an end. And it appears to be a total crapshoot which side ends up winning the battle.

Overbought in a Downtrend: PTEL by kensey

Powertel Inc (PTEL)



A phenomenal shorting opportunity presented itself when Powertel Inc (PTEL) bounced in late September. Since this was an actual trade, we've got an annotation in the form of a blue dot that marks the spot.

One key to success in using stochastic to look for shorting opportunities is to zero in on a stock that is in a persistent downtrend. This is clearly the case here. Red bars dominate the price graph and the short ill-timed green bars mark where Powertel tried to come up for air and failed. **As is always the case when evaluating the colored bars on top of a price graph, the color that dominates is the one that counts.**

As evidence of this downtrend, note that the centerline of the MACD indicator graph is pushed towards the top (the MACD indicator graph is third from the top in the set). This means the lines are below the centerline more often than not. **That means one thing - downtrend.**

In late September, prices bounced and went from 10 to 15 dollars a share. The first thing to note is that **the bounce occurred on thin volume.** This is demonstrated by the blue bars on the volume indicator graph, which stack small when compared to the red bars that were behind the selling volume during the month of August. So volume was weak during the bounce. That's negative.

The time to short was signaled by stochastic (the stochastic indicator graph is the one on the bottom). The stochastic lines formed an 'inverted pail' during the bounce. They went into overbought and stayed there. The stochastic lines go into overbought when they cross the upper reference line. This was due to the fact that the rise in prices was very linear and **prices closed near the intra-day high almost everyday.** The stochastic algorithm is sensitive to where prices close relative to the intra-day range. If prices close near the high end, the stochastic lines point and move upwards. If the lines are already in overbought territory when this happens, they stay there.

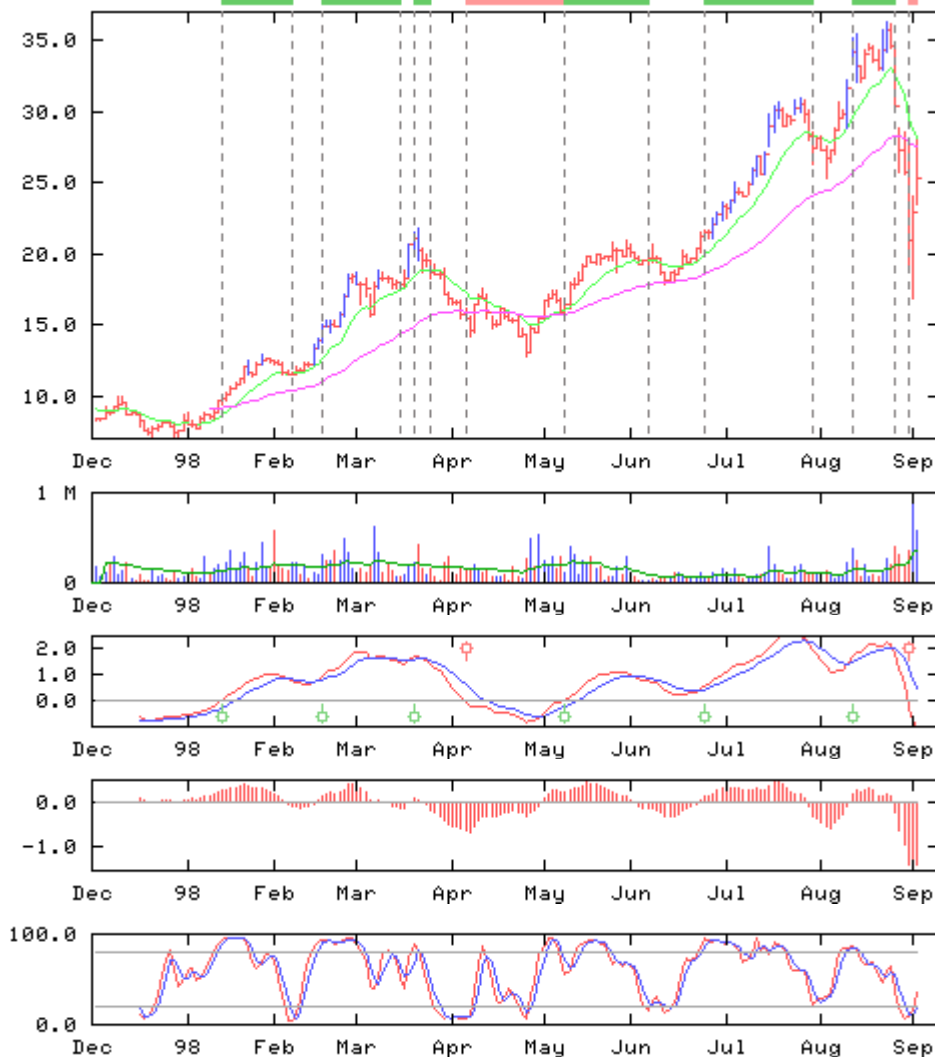
When prices started to cup right before the leg down, stochastic fell out of overbought. When the stochastic lines start turning down is when you place the short sale. Actually, shorting as prices were cupping would have been better, but that is a harder opportunity to spot.

This situation can be summarized as follows:

- MACD Downtrend
- + Stochastic Overbought
- + Weak Volume during the bounce
-
- Excellent Shorting Opportunity!

What Stochastic Should Be Telling You by kensey

Metromedia Fiber Network Inc A (MFNX)



This stock hasn't really traded very long, so its indicators don't have much track record. Nevertheless, stochastic pointed out an excellent buying point for this stock in early February.

The more you study stochastic, the more it should be starting to lead you through the following thought process:

- MACD is important in telling us which way a stock is trending. It tells us whether to buy or sell.
- But MACD doesn't tell us precisely when to pull the trigger and act on the information.
- Stochastic tells us that you never have to worry about a market running away from you, so don't rush when buying a stock.
- Stochastic tells us that it pays to have patience and wait for **both** MACD and stochastic to be issuing bullish signals before you jump the gun.

So what happened to MFNX's trading activity in late March/early April? As you can see on the stochastic graph, it formed a pail. This formation is called a pail because it resembles the bottom of a bucket. This was not a buying opportunity. Not just in hindsight, clearly at the time: prices at this point had cut way below the 13-day EMA and the MACD lines were nose-diving. When this happens, you have to be much more careful in your use of stochastic. Since stochastic is such a short-term indicator, it can sometimes be misleading. This is why we stress that it should only be used in conjunction with MACD. If MACD is totally breaking down, there is a lot more risk in going long.

The dive below the lower reference line in late April doesn't appear to have been a clear-cut opportunity either, although it happens that this trade would have worked. But the action in the MACD lines is not very definitive. Look at the shape of the lines in early February, then look at all the rest of them. Only the clearest

of formations are reliable signals. When stochastic lines start flapping around, they become more ambiguous.

Deriving Stochastic by kensey

Merck & Co Inc (MRK)



Does the technical definition of stochastic mean much? Do you need to understand how it's derived in order to use it?

I don't consider it that important, but we provide a definition. Of course, I had to look it up when I wrote the algorithm to calculate the data points. But since then, I haven't needed to refer to it.

One thing that is important to me is how MRK, which was in a very strong MACD uptrend since it gapped up in December, is depicted as being very oversold around February 4. This was a very good buying opportunity. The shape is very clear cut, and MACD didn't break down.

Pattern-matching in your brain is key, as is knowing that if a stock is in an uptrend you should use stochastic to identify oversold conditions and get in.

The other important thing to know is that stochastic detects when the current price is out of range relative to where it has been trading in the recent past. Additionally, stochastic detects when the clustering of prices at this extremist level is rounding off and prices look poised to swing back in the direction of the longer-term trend.

So what happened in April when an oversold stochastic turned out to be a bad signal? This proved to be a harbinger of what has happened to MRK since. When a stock fails to rally from an oversold stochastic when it is in a bull trend, weakness usually lies ahead. If you own a stock that is in an uptrend and you notice that following an oversold stochastic reading as it continues to head lower, it's time to get out. (That is, if you have the timeframe of weeks to months in mind, which is what ClearStation is geared towards.)

So even if you don't trade off the technicals, it pays to observe them and know what they mean so you know what to expect from the stocks you are holding long term.

If you would like to know more about the technical description and definition of stochastic, keep reading...

The stochastic oscillator compares where a security's price has closed relative to its price range over a specific period of time. George Lane, who developed this indicator, theorized that in an upwardly trending market prices tend to close near their high, and during a downward trending market prices tend to close near their low. Further, as an upward trend matures, price tends to close further away from its high; and as a downward trend matures, price tends to close further away from its low.

The stochastic indicator attempts to determine when prices start to cluster around their low of the day for an uptrending market and when they tend to cluster around their high in a downtrending market. Lane's theory is that these are the conditions that indicate a trend reversal is beginning to occur.

The stochastic indicator is plotted as two lines. They are the %D line and the %K line.

The D line is more important than the K line. The stochastic is plotted on a chart with values ranging from 0 to 100. The value can never fall below 0 or above 100. Readings above 80 are strong and indicate that price is closing near its high. Readings below 20 are strong and indicate that price is closing near its low.

Ordinarily, the K line will change direction before the D line. However, when the D line changes direction prior to the K line, a slow and steady reversal is usually indicated.

When both K and D lines change direction, and the faster K line subsequently changes direction to retest a crossing of the D line, but doesn't cross it, this is a good confirmation of the stability of the prior reversal.

A very powerful move is underway when the indicator reaches its extremes around 0 and 100. Following a pullback in price, if the indicator retests these extremes, a good entry point is indicated.

Many times, when the %K or %D lines begin to flatten out, this is an indication that the trend will reverse during the next trading range.

Quite often, divergence is set up on the chart. That is, price may be making higher highs, but the stochastic oscillator is making lower lows. Conversely, price may be making lower highs, and the stochastic oscillator is making higher highs. In either case, the indicator is usually demonstrating a change in price before price itself is changing.

The formula for %K is as follows:

$$\%K = 100[(C - L5_{close})/(H5 - L5)]$$

Where:

- C = the most recent close
- L5 = the lowest low for the last 5 trading periods
- H5 = highest high for the same five trading periods

%D is a smoothed version of the K line. Usually, three periods are used. The formula is as follows:

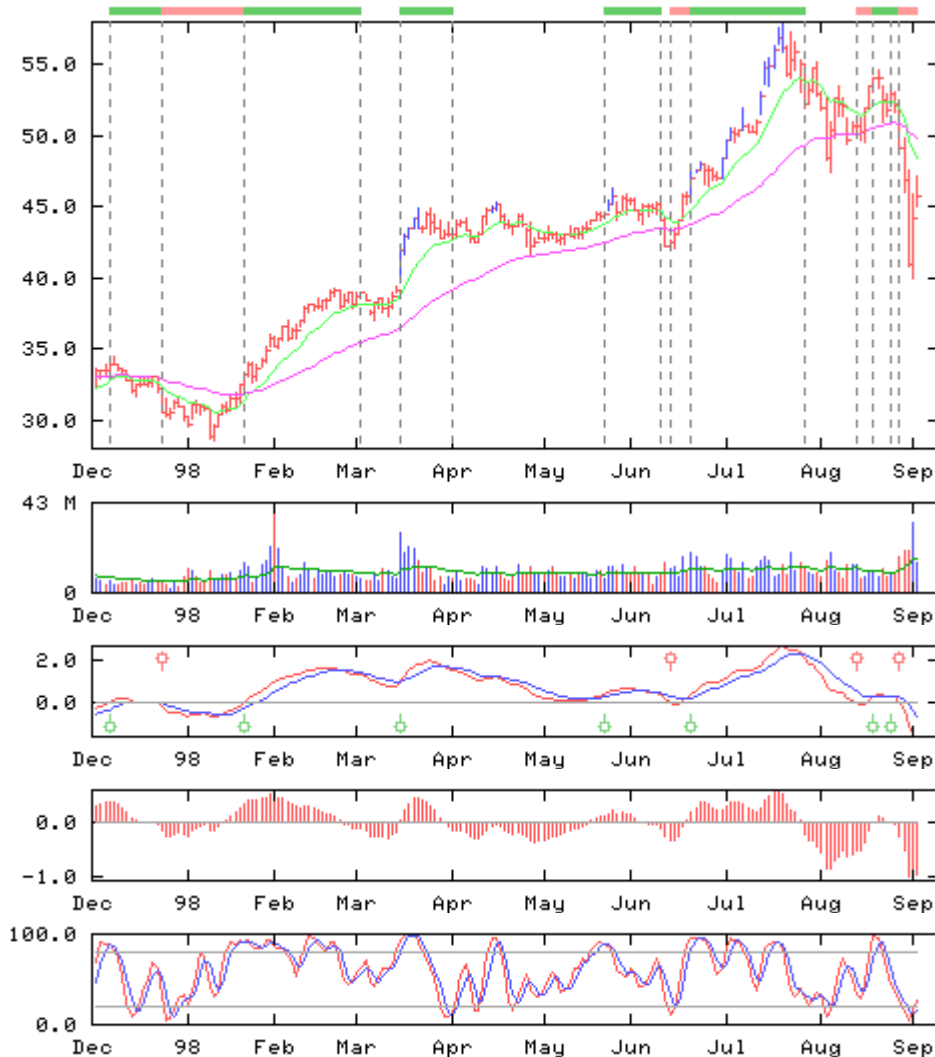
$$\%D = 100 \times (H3/L3)$$

Where:

- H3 = the 3-period sum of (C - L5)
- L3 = the 3-period sum of (H5 - L5)

Overbought in an Uptrend: WCOM by kensey

Worldcom Inc (WCOM)



On the stochastic (bottom) indicator graph, WorldCom went into overbought territory in January and stayed for over a month. Is this a big deal? Not exactly.

When WCOM went MACD bullish (green) in mid-January, it was already overbought as far as stochastic was concerned. But this was a case where the MACD trend was more important than the short-term stochastic reading - MACD was above the centerline (the third graph down), so overbought wasn't much cause for alarm.

The overbought reading on stochastic that occurred in early December was more a cause for concern because MACD was way below the centerline at the same time. In other words, this stock was acting strong short-term but was in a longer-term pullback. This typifies your "overbought in a downtrend" scenario.

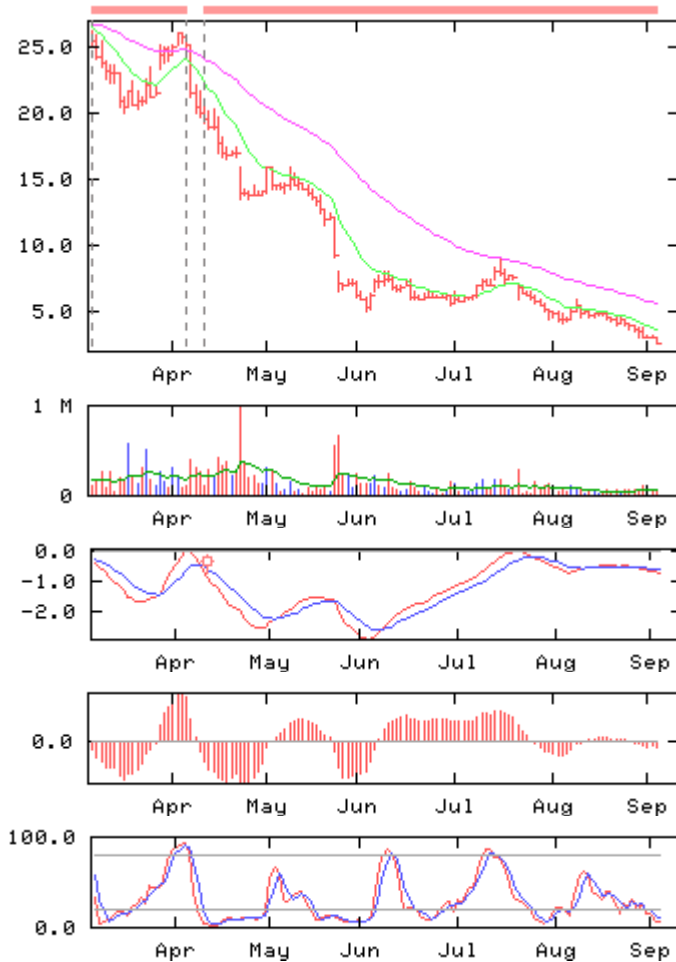
That wasn't what was going on in January and February when the stock was rebounding.

It is important to identify the change of trend. Stochastic gives the wrong signal when stocks shift from a downtrend to an uptrend. (It's always going to be overbought in such a case.)

Is it crystal clear that WCOM switched from a downtrend to an uptrend in mid-January? Yes. The thing to note is that the MACD lines crossed over the centerline in a pretty smooth and graceful manner. There was no dramatic plunge beneath the centerline that occurred during the January 1 slide. The basing action was therefore healthy and the stock, when it turned above center, vamped up in a healthy way.

Stochastic Mannerisms in a Downtrend: TDDDF by kensey

3dlabs Inc Ltd (TDDDF)



When a stock is in a strong downtrend, the lines on the stochastic indicator graph will spend the majority of their time down around the lower reference line. A good way to interpret this is as "persistent short-term weakness".

Nevertheless, short bursts of buying will inevitably cause the stochastic lines to make their way to the upper reference line. These are near-perfect shorting opportunities, because often, once a stock goes into a severe downtrend it never seems to recover.

For TDDDF, the first decent shorting opportunity occurs all the way on the left-hand side of the stochastic graph in early April when a spurt causes the lines to cross into overbought. Once the lines leave the overbought region, they fall very hard and very fast and bury themselves beneath the lower reference line in oversold territory for most of the next two months. Only in early May do the lines try to escape the clutches of oversold, only to be sucked back in. The stock gets chopped from 25 all the way down to 5.

The next shorting opportunity happens in early June, with the stock down at 8 dollars a share. The symmetrical shape of the stochastic lines as they cross into overbought is exactly what you want to see: a very clean shape.

But the shorting opportunity in July is even better. The shape of the stochastic lines as they cross into overbought is wider (like a bell curve). The stock hits the 50-day EMA (pink) line. Once it exits overbought, the stock heads straight into oversold and, by the end of August, gets chopped from 9 to around 2. This seals the fate of TDDDF (at least for now). As was the case in early May, the stock made an attempt to escape the clutches of oversold only to get half-way up the scale before getting sucked back down.

A Truly Oscillating Stock: SEG by kensey

Seagate (SEG)



Oscillation is range bound price action that occurs in waves. When you see many consecutive, ill-timed trending bars, you should recognize that as a symptom of oscillation rather than a definitive trend. In most cases, oscillation is not something to look for in a stock.

Price action for Seagate (SEG) can truly be characterized as oscillation. The big tip-off is the ill-timed MACD trending bars. However, these waves are smooth: about three weeks in length. In this instance, the waves are long enough to open windows of trading opportunity in both directions that have a high probability of success.

The stochastic indicator graph (which is the last graph in the set) encapsulates Seagate's oscillatory nature accurately. There have been four excellent trading opportunities since July:

1. When the stochastic lines emerged from oversold in late July (**go long**)
2. When the stochastic lines emerged from overbought in mid-August (**go short**)
3. When the stochastic lines emerged from oversold in late August (**go long**)
4. When the stochastic lines emerged from overbought in mid-September (**go short**)

Note the last one in mid-September. There was a little bit of a feint where the lines emerged from oversold, dropped down a bit, and then went back into oversold again. This could have caused you to get shaken out (especially if you had CNBC on and the world was mightily bullish that day, which is a reason to keep it off -- you either reference the euphoria of sentiment or the chart). The main reason is that the 13-day EMA was still pointing higher when stochastic went into oversold. **You want to wait until the 13-day EMA is flattening out before you enter a short trade based on stochastic.**

At the extreme right edge, you once again have the lines in oversold territory about to start heading up the chart. What do you do? I would be cautious. The 13-day EMA is still pointing down so it might be a bit early to go long right here. But the market is oversold and due to bounce, and the downside risk appears slight. Also, down volume this week for Seagate was low.

Oversold in an Uptrend: VKNG by kensey

Viking Office Prods Inc (VKNG)



I love it when I see written on some Yahoo message board how full of crap technical analysis is. The next time I see it, I want to throw in a URL to this post.

After gapping up in mid-May, Viking did what lots of stocks do after a big gain - it came straight back to touch the 13-day EMA. Now, this doesn't happen every time, and you probably would only have been aware of this if you had either entered in a position on the day it gapped, or threw VKNG on your Watch List and then noticed the oversold condition on your Focus page.

Stochastic was classically oversold in late May. This afforded a very timely trade. This trade banked on the fact that the gap was going to hold up. Really, the volume that brought the stock to stochastic oversold was very small compared to the volume that drove the stock up on the day of the gap.

A second opportunity for trade came in mid-June. Same exact scenario. Viking got extended and came back to its 13-day EMA. At the same time, stochastic once again crossed into oversold.

Stochastic Mannerisms in an Uptrend: KSS by kensey

Kohl's Corp (KSS)



Kohl's went MACD green in early May. The action in stochastic over the next month is what you will see during a very strong uptrend - the lines linger in the upper half of that indicator graph. The trend is so strong that stochastic remains close to overbought levels.

In this case, it would have been hard to use stochastic to time an entry. It never gets to an oversold level. This is a reason that you do not necessarily want to wait for stochastic to become oversold in order to buy your first position in a stock. You might end up waiting a very long time, and you might miss the trade entirely if there isn't a pullback significant enough to pound the stock below the lower reference line to an oversold level. Stochastic is best used to establish pyramid points. A pyramid point is a price level at which you buy additional shares in order to add to an existing position.

When I first buy into a stock that has just gone MACD green, I don't like it if the stochastic lines make an immediate journey to an oversold level. I don't like the lower reference line to be penetrated, especially if the pullback in prices results in a paper loss. I much prefer (and demand) that stocks in which I make an initial trade stay relatively high on the stochastic graph. You could let a month or so go by before selling pulls it to oversold, but be wary if it happens too soon.

The action in stochastic during May and early June is exactly what I like to see. Healthy price action that keeps the lines up on the stochastic indicator graph. It is not until mid-June that stochastic almost reaches oversold. This happens again in mid-July. While prices did not penetrate the lower reference line, both of these points are legitimate pyramid points. The reason is that relatively speaking, the stochastic lines were a lot lower than they had been for the prior six weeks. It's all relative. The stochastic lines do not necessarily have to penetrate the lower reference line in order to become "oversold," especially with a stock in the midst of an uptrend as strong as Kohl's.

You can qualify the strength of an uptrend by how long and how hard the stochastic lines stay up. You can also qualify the strength of a downtrend by how long and how hard the stochastic lines stay down.



ClearStation Education: Patterns

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Patterns

Support and Resistance Lines

Trend Lines

Price Action

Remember searching for images in the clouds as a child?
Pictures of faces or trees...

Looking for patterns in the price action of a stock is really not much different. It's merely finding shapes on a graph that help you identify patterns in the way the price moves. Sometimes, the patterns can even predict the future action of a stock's price.

In this section, you'll learn:

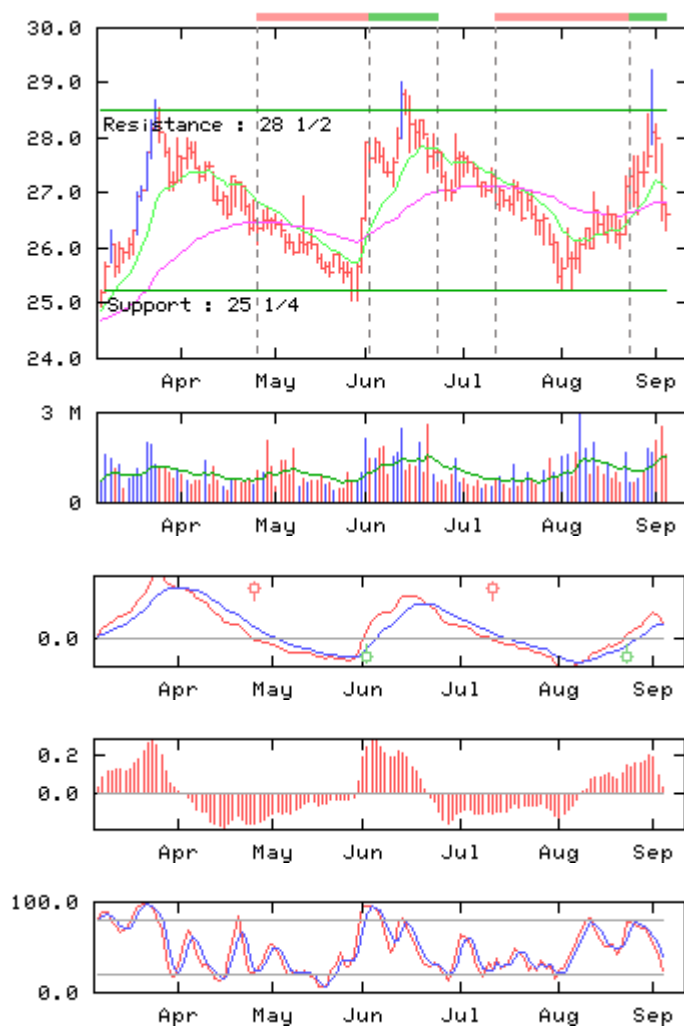
- About **support, resistance, and trend lines**
- How to use them to determine **price action**
- The significance of **gaps** in prices
- How to identify certain **patterns**

The Importance of Support and Resistance by kathia

Understanding how support and resistance lines work is important; understanding how to use them is invaluable!

Support and resistance are price levels. Support is a level that a stock's price doesn't fall below. Resistance is a level above which a stock's price cannot seem to rise. Support acts like a floor, resistance acts like a ceiling, and a stock's prices bounce between the two.

Southern Co (SO)



Does it sound complicated? It's not really. It's all about seeing patterns in the movements of a stock's price. In essence, the lines are mapping traders' buying and selling patterns. Those patterns can help predict whether trends will continue or reverse.

Depending on its strength, a support or resistance line can pause or reverse a downtrend. Its strength is determined by many factors:

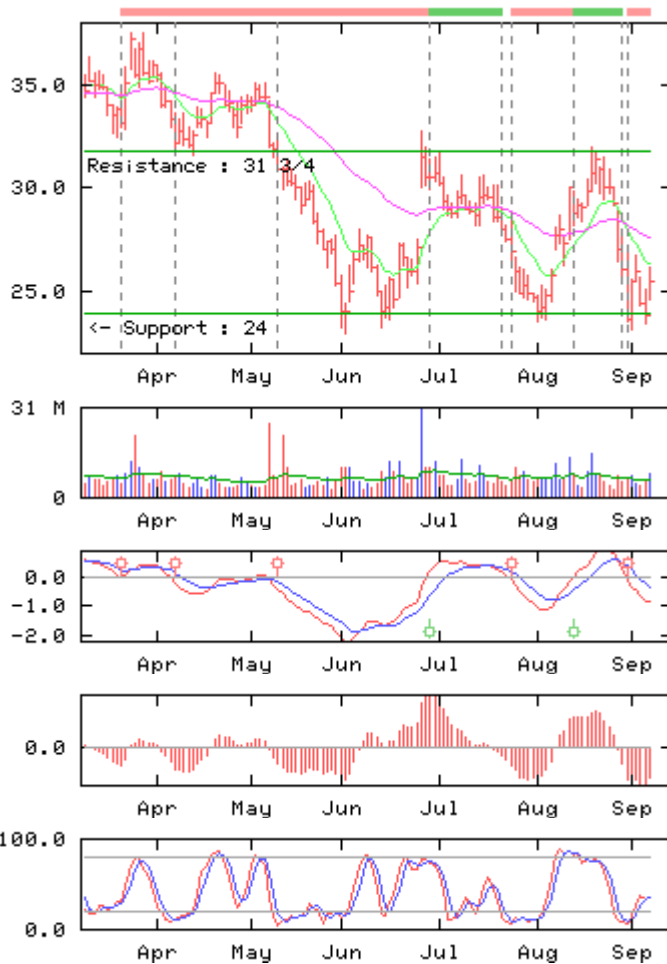
- **The length of time that it serves as a support/resistance line and the number of "hits" it has taken.** The longer the period of time, the greater the strength of the line.
- **The distance between the support and resistance line.** The farther apart the two lines are, the stronger each line is.
- **The volume of shares being traded.** The strength of the support and resistance lines increases if trading is very active while the price is bouncing between the lines.

A support line can pause a trend, but a strong support line will reverse it. A good example is SO. The downtrend that was in effect in May was sharply reversed at the end of the month as the price bounced off of the support line.

Resistance lines work in much the same way. A resistance line can pause an uptrend, and a strong one can reverse it.

Banded Support and Resistance: COMS by kensey

3Com Corp (COMS)



3Com stock has been oscillating for the past four months. Right here in early September, 3Com is sitting near historical support at 25 dollars a share.

The last three times 3Com has approached this price level, buyers have come in to push the stock higher. 3Com is technically weak right now - the trending lines of MACD are below center and as a result, a red MACD trending bar is up.

Note, however, that most of the recent MACD trending bars are ill-timed. What this means is that 3Com stock is oscillating and, therefore, is not trending. So using MACD to time trading decisions would be an ill-advised.

Instead, you should use stochastic to time your trading decisions. You will note that whenever 3Com stock touches the support line at 24, stochastic is oversold. In addition, when prices touch the resistance line at 31 3/4, stochastic is overbought. So, you want to buy the stock when the stochastic lines cross over the lower reference line and sell the stock (or go short) when the stochastic lines cross below the upper reference line.

At the right-most edge of the graph, the stochastic lines are crossing over the lower reference line so you would want to look to buy the stock even though we are in MACD red.

If a trade is placed at this price level, a stop should be used in case prices fail to rise and the lower support line is pierced. As you can see at the left edge of the graph, prices crossed below the resistance line at 31 3/4 (at that time it was a support line), and it has not made it back over that line since. Same case here. If 3Com drops below support at 24, that line will probably serve as a resistance line in the future.

Breaking Below Support: AVEI by kensey

Arterial Vascular Engineering (AVEI)



June 6, 1998

Ever since AVEI broke below support at 33, there has been continued weakness in the stock. It has been below its 13-day EMA, and the damage underneath the MACD red trending bar continues to mount.

When a stock breaks below established support, it can be expected to act as a resistance line. In other words, once a price breaks below a support line, it flips its role and becomes a resistance line.

So, I would look to be a seller if prices were able to rally back and approach this line. Given that the stock is at 30 as I am penning this article, this increasingly seems unlikely, and I am eyeballing the next support line for this stock, which appears to be at 25.

Eyeballing support and resistance lines is worthwhile. ClearStation allows you to annotate graphs with your own lines that are not visible to other users unless you recommend the stock. There is an action item called "Annotate" that can be found when you are viewing any stock.

Banded Support and Resistance: ASAI by kensey

ASA Holdings Inc (ASAI)



What are the funny horizontal green lines on the ASA Holdings (ASAI) price graph? They are called "banded support and resistance lines." They are included to help you gauge clearly the price action of a given stock.

For ASAI, the middle line is drawn at 40 1/2. This is a resistance line. When prices approach it, it resists further advances. The lower line is drawn in at approximately 36. This is a support line. When prices approach it, it acts to support prices and ward off further declines.

For the past four months, prices have oscillated between these two lines. At 40 1/2, sellers appeared and prices were forced back down. At 36, buyers stepped in and prices were forced back up. It has been a battle of two equal and opposing forces. These lines help to illustrate important facets of crowd behavior among traders, namely that their activity often follows predictable patterns.

So what do these lines mean in relation to broader market forces?

It is helpful to examine this stock in terms of the overall "strength of the domestic economy." The only reason the DOW has declined by only three percent from its top, and the broader based S&P 500 has declined only four percent from its top is the current state of the US economy. Growth is strong, interest rates remain low, and inflation is nonexistent. Add to this equation the recent decline in oil prices, and you have an environment in which this particular small airline carrier can prosper.

Who cares?

I do! ASAI has broken above resistance at 40 1/2. This suggests the dawn of a new era and the possibility that resistance at 40 1/2 may soon become support at 40 1/2. In other words, it's role-reversal time. This is typical once a historic level is crossed (in either direction). So if ASAI is not able to hold above the newly crowned support line at 40 1/2, then all bets are off.

Staircasing: PIXR by kensey

Pixar Inc (PIXR)



June 16, 1998

Pixar, besides having a really cool corporate name, lives its life in a most interesting manner of periodicity. It's a classic stair climber that uses 8 point steps. This is illustrated with some annotated lines on the price graph.

Both of these lines represent resistance lines. The price touched these lines a number of times before breaking through and, in the process, gave the stock a higher altitude in which to live.

Pixar shot up today by 3 points to close at 47 1/2. For the past 6 weeks it had been leveling at 44 dollars a share. Before that, it spent about 6 weeks leveling at 36 dollars a share. The MACD graph captures this quite well. Once the Pixarian foot lands on the next stair, it starts a gradual ascent down. Once the foot is ready to go up again, it starts to arc back up. Right now, it is starting to arc back up, similar in manner and form to the prior two steps. Some other ducks: a 52-week price high was hit, the volume was totally there, and the close was right at the high of the day.

So, if things go as expected, we are looking for an ascent to somewhere in the low 50's. If the next step is missed, this will mean a price break below 44. That's the signal for action, before a fall down the stairs is taken. 44 dollars a share.

Descending Triangle: IDTC by kensey

IDT Corporation (IDTC)



Between April and August, IDTC was caught in what we call a "descending triangle". This is a geometric abstraction of a region in which prices have been effectively contained. That is, prices have been trapped inside and are looking for a way out.

A descending triangle is composed of two lines (the third side is open).

One line is the horizontal support line (drawn in at 24 1/4). As prices move lower and reach the price level at which this line is drawn, they reverse and turn higher. This barrier becomes more formidable each time it bounces prices.

The second line in this configuration is a trendline that represents a cap on prices. As prices hit this line, they bounce off and move lower. The trendline has a downward slope that reflects the stock's descending price level (at which IDTC has been peaking in its failed rally attempts).

Simply put, prices reach the support line at 24 dollars a share. They then bounce upward off this line. The price at which IDTC has been able to rally after the bounce is getting progressively lower and lower. This forms the triangle.

As prices near the apex of the triangle, the vertical range in which they are confined gets narrower. Pressure builds up and a potentially explosive flash point is created. It is here that prices escape the triangle, which usually happens quite violently and decisively.

Remember: you should trade in whichever direction the stock escapes the triangle.

In this case, prices broke the support line in early August. Subsequently, a solid week silently passed by in which there was a window to get a decent fill on a short trade. As is typical when a descending triangle is broken on the downside, prices bumped against the support line from underneath it before finally breaking down. In this case, there was an 8-point drop in less than two weeks.

Descending Triangle: CCR by kensey

Countrywide Cr Inds Inc (CCR)



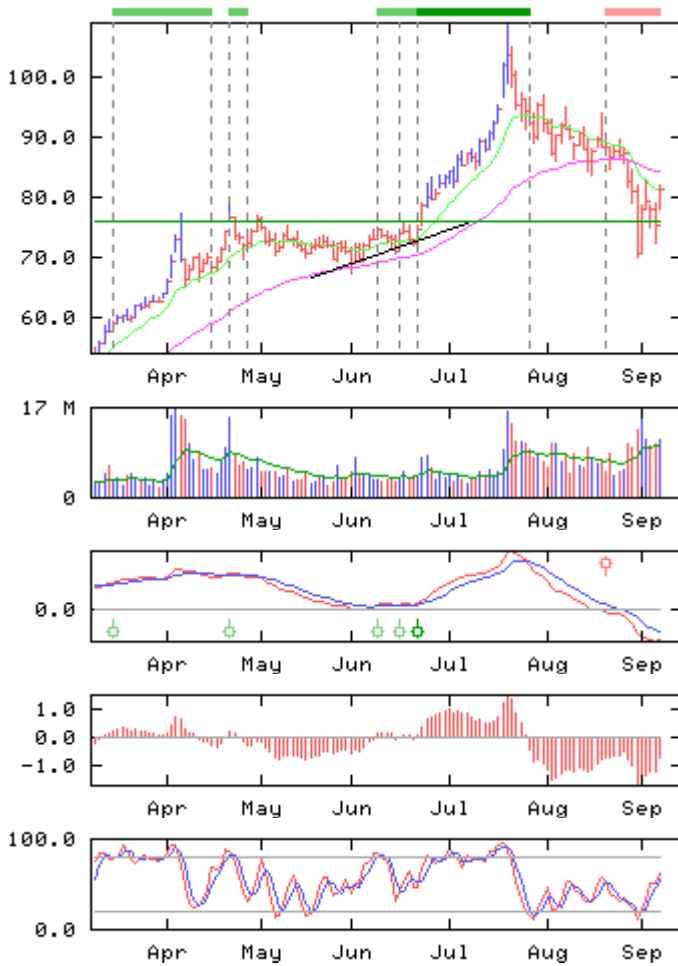
Countrywide broke out on the upside of a descending triangle in the beginning of June. This happened only a few days before a green MACD trending bar was put up, so this event served as a very timely heads-up.

The uptrend from that point on was remarkably consistent, as shown by the persistent strength in stochastic and the even spacing between the MACD lines as they work up toward the top of that indicator graph.

It is interesting to note that after Countrywide went into a bear trend (as indicated by the start of a red MACD trending bar in late July), prices hovered underneath the support line drawn in at 45 in mid-August. It was mostly a guessing game until the drop started in late August and shaved off 10 quick points. The only warning was that one day when prices nosed above the support line intraday but weren't able to hold that level.

Ascending Triangle: LU by kensey

Lucent Technologies Inc (LU)



In the beginning of June, Lucent entered an ascending triangle configuration. This pattern usually indicates a consolidation, and should be watched closely: the way it breaks offers a clear signal on how to trade.

An ascending triangle is composed of two lines. One is the horizontal resistance line (drawn in at approximately 76). As prices move higher and kiss the price level at which this line is drawn, they reverse course. This barrier becomes more formidable each time it bounces prices.

The second line in this configuration is a trendline that represents a floor. As prices hit this line, they bounce and move higher. The trendline has an upward slope that reflects Lucent's progressively higher price levels.

As prices near the apex of the triangle, the vertical range in which prices are confined gets narrower. Pressure builds up, as if a coil of a spring is slowly being compressed. The closer prices get to the apex, the higher the pressure. You can see that when prices escape the triangle on the upside, volume increases. There is no more hesitancy in price action as prices rapidly escalate from the mid-70's all the way to over 100 dollars a share.

Pennant: CPQ by kensey

Between February and July, Compaq Computer formed a very clear pennant. A pennant is a consolidation pattern in which the probable direction of future prices is clearly indicated.

Before the advent of computers, consolidation patterns were delineated with lines hand drawn on graphs, and even then, these lines were considered dependable. ClearStation offered annotation as of one of its first features so members could outline consolidation patterns as soon as they spotted them.

A pennant is formed by two trendlines - one that slopes down and one that slopes up. The angle of both lines should be equal. These lines pinch prices into the apex and create an inflexion point where a determination is made as to which trendline has staying power.

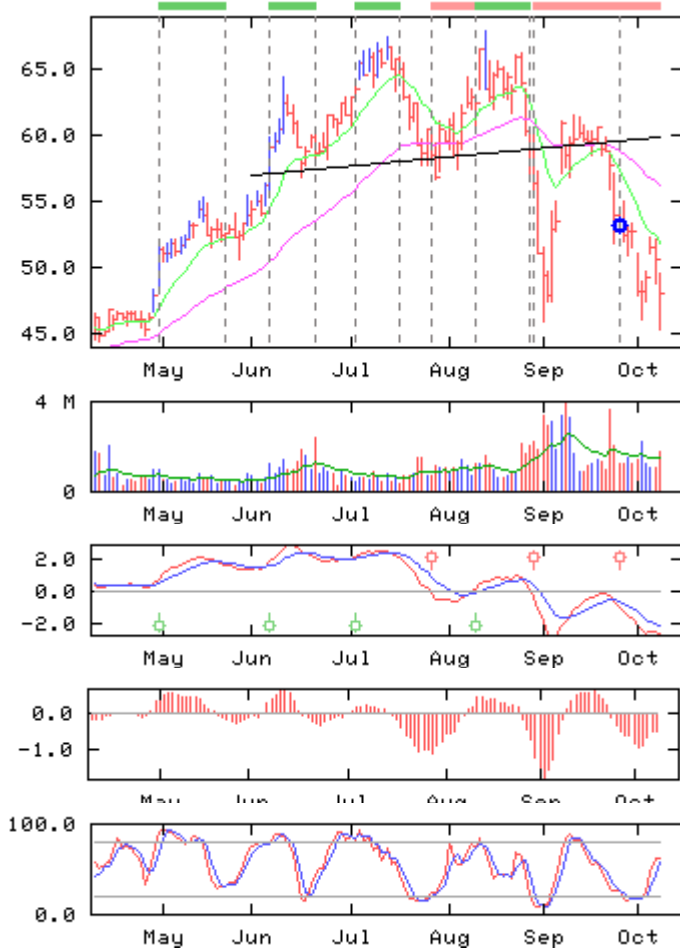
Compaq Computer Corp. (CPQ)



You will note here that volume in June dries up as prices approach the apex but increases substantially in early July when the upper trendline is decisively crossed. Without an accompanying pickup in volume, the exit of the pennant formation might be a false breakout.

Head-and-Shoulders Top: GPS by kensey

Gap Inc. (GPS)



The head-and-shoulders top is a tenet of classical charting theory, one invented when trading off price action was accomplished using pencils and rulers.

It suggests that buying in a bull move is composed of three waves - smart money, dumb money and dumber money. Underneath each of these waves is drawn a 'neck-line', which represents the approximate points at which prices fade off the peak of each wave. Such a line is drawn on the price graph at left.

Wave 1 consists of smart money and forms the left shoulder, encapsulated by the MACD green trending bar of June. It represents the activity of a syndicate of buyers operating 'in secret', quietly accumulating shares. These buyers have a 'real reason' to pick up shares, one derived from research. These buyers are not momentum investors (as at this point there has not been enough momentum to attract their attention).

Wave 2 consists of dumb money and forms the head. These buyers missed the first big move up, the strength of which attracted their attention in the first place. They take advantage of the fade in prices off the peak of the left shoulder and use it to aggressively accumulate shares. The move up caused by this wave of buying is encapsulated in the MACD green trending bar in early July.

It is during the fade off the top of wave 2 that the syndicates responsible for the first leg up start to unload shares. Since they have been vested in the stock from the beginning, they recognize when things are getting 'frothy' and are scared by the frantic buying of the momentum crowd (who are more concerned with missing 'the next big thing'). It's sort of like the end of a party where all the suits have gone home and you are left with a bunch of milling drunks. Prices fade back to the neckline.

Wave 3 consists of dumber money and forms the right shoulder. This last group of buyers missed both waves 1 and 2 and looked at the fade in prices as yet another buying opportunity. These investors consist of both new money and those who entered positions late in the second wave and are thus sitting on paper losses. The volume in wave 3 is typically weaker than that forming the head and the left shoulder. So the rise in prices here is short lived due to the fact that it is even less grounded than the rise that formed the head.

Once prices fade off the right shoulder, the formation is confirmed when prices break below the neckline. This happened rather dramatically in the end of August when Gap shares plunged into the upper 40's.

This move was exacerbated by the decline in the broad market, and was actually somewhat 'out of the formation' move.

As is typical with such formations, prices come up from beneath the neckline and touch it. In this case prices swung over the neckline and just sat there for a week. Look at it! Guess the next move! This is where the short hammer is dropped.

Sounds like a lot of work, right? Wrong. This formation is so predictable that when a really good one is found (as you can see, there are a lot of conditions that must prevail for it exist fully) you are looking at a chance to trade with a high degree of success and a low amount of risk.

Actually, any stock where prices cup when a red MACD trending bar is above the price graph is usually a good opportunities for short trade. Speaking of MACD, notice how the rounded peaks of the lines get lower and lower on that indicator graph? This confirms and encapsulates all of the above.

The book that covers this Head-and-Shoulders formation (and others) is called Technical Analysis of Stock Trends by Robert D. Edwards and John Magee. This book is **a must**.

Gap Down in Prices: MSPG by kensley

MindSpring Enterprises (MSPG)



The support line at \$26 dollars is a very important line for MindSpring shares. This line has history; it is the single most important line on the chart of this stock. 26 marks the low that was reached in August and September during the anomalous retreats of the broad market. 26 marks the high back in April. 26 marks the point level through which the stock gapped up in mid-June and then doubled.

The issue facing MindSpring shares is a Gap Down in prices at the extreme right edge of this chart. This happened during the high-volume down day in the first week of October (and coincided with the advent of a red trending bar). A pair of short lines is drawn onto the price graph to represent the Gap Down.

The gap exists because shares did not trade in the range the gap represents (which is $31 \frac{1}{2}$ - $32 \frac{3}{4}$). Shares closed the previous day above the gap, and the next day the range of trade was entirely below.

Gaps only occur on daily charts in reaction to negative news reported while the market is closed. Had the "event" that caused the gap happened while the market was open, you would see an unusually wide range of intraday prices, but no gap.

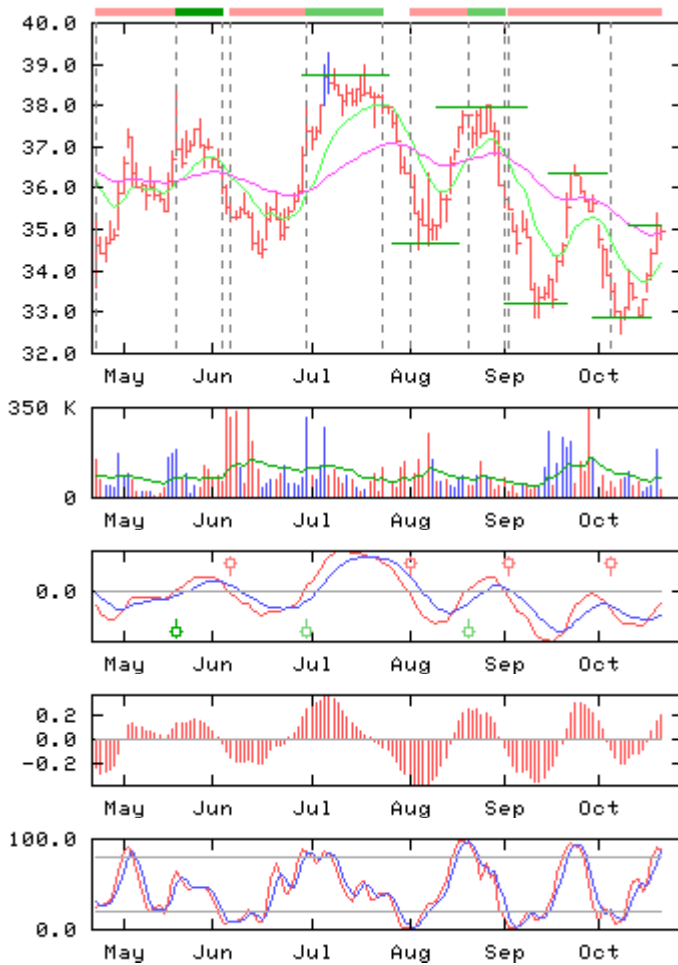
Gaps are caused by an imbalance of buy and sell orders. In the case of a Gap Down, a large number of sell orders (or one huge sell order) placed overnight have to be cleared before the stock can start trading. So the stock gets marked down until the large block being sold by the seller has found a buyer. If the news is especially bad, the gap is proportionately larger.

The price level through which prices gapped down usually becomes a point of future resistance. If prices start to recover and return to the price level of the gap, they tend to get pushed back down. On the other hand, it is bullish if prices are able to cross over the gap (at which point it tends to become an area of support).

But it usually takes a couple of tries. In almost all cases, the first attempt gets pushed back. This is, in fact, what happened to MindSpring: right after shares gapped down and reached support at 26, they bounced up, but only got as far as the gap before they were pushed back down.

Downtrend in Prices: GGP by kensey

General Growth Pptys Inc (GGP)



General Growth Properties (GGP) is in a classic downtrend. In a downtrend, each decline in prices falls to a lower low than the preceding decline and each rally stops at a lower point than the previous rally.

In a nutshell, a downtrend consists of lower lows and lower highs.

Stocks rarely go straight down, but descend in a series of downturns.

The biggest hint that a stock is in a long-term downtrend (this one is going on 4 months) is the fact that most of the MACD trending bars on top of the graph are red. The green trending bar that occurred in mid-August was a head-fake. You can tell that this bar is suspect because prices at the point when the bar went up are lower than the peak in prices in July.

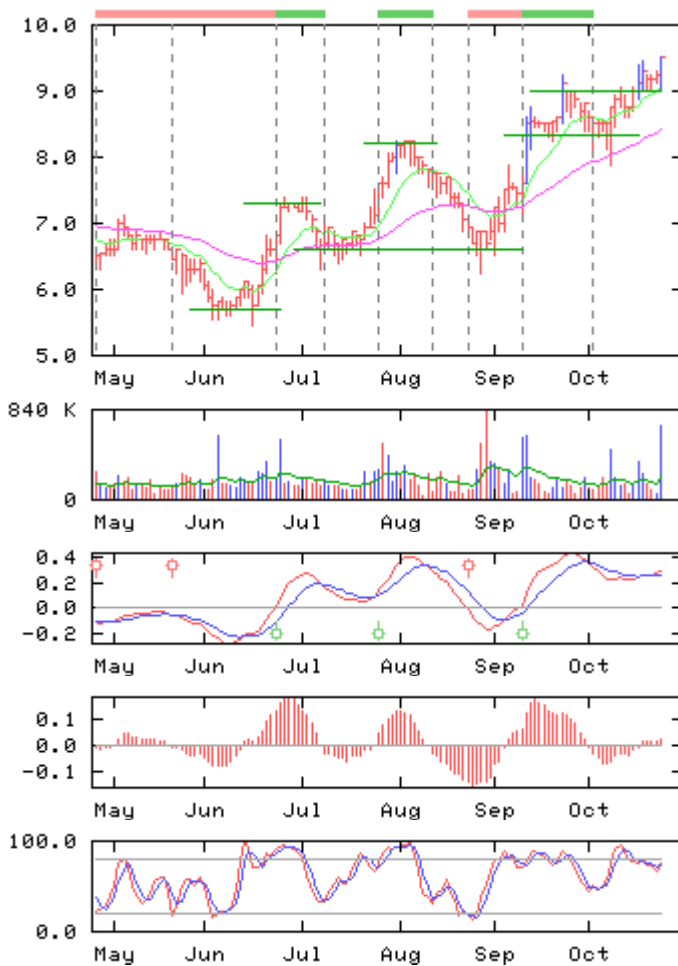
You need to pay attention to where a stock peaks. If a green bar goes up and prices are at a lower high than the prior peak, I usually wait to see how the stock acts on a fade. If that fade arrests itself and green is able to persist, then I'll consider the buying the stock.

Note the stochastic indicator graph on the bottom. It accurately predicts the fall and rise of prices. When the stochastic lines cross below the upper reference line (exit an overbought condition), prices tend to fall. When they cross above the lower reference line (exiting an oversold condition), prices tend to rise. Stochastic is covered in detail in another section, but note this for the record.

The MACD indicator graph is the third from the bottom. It traces curves that sink lower and lower down as the downtrend persists. This points out the stock is weakening. MACD is also covered elsewhere, but note this for the record too!

Uptrend in Prices: PLP by kensey

Phosphate Resource Partners Lp (PLP)



An uptrend in prices is a series of higher highs and higher lows. It's that simple.

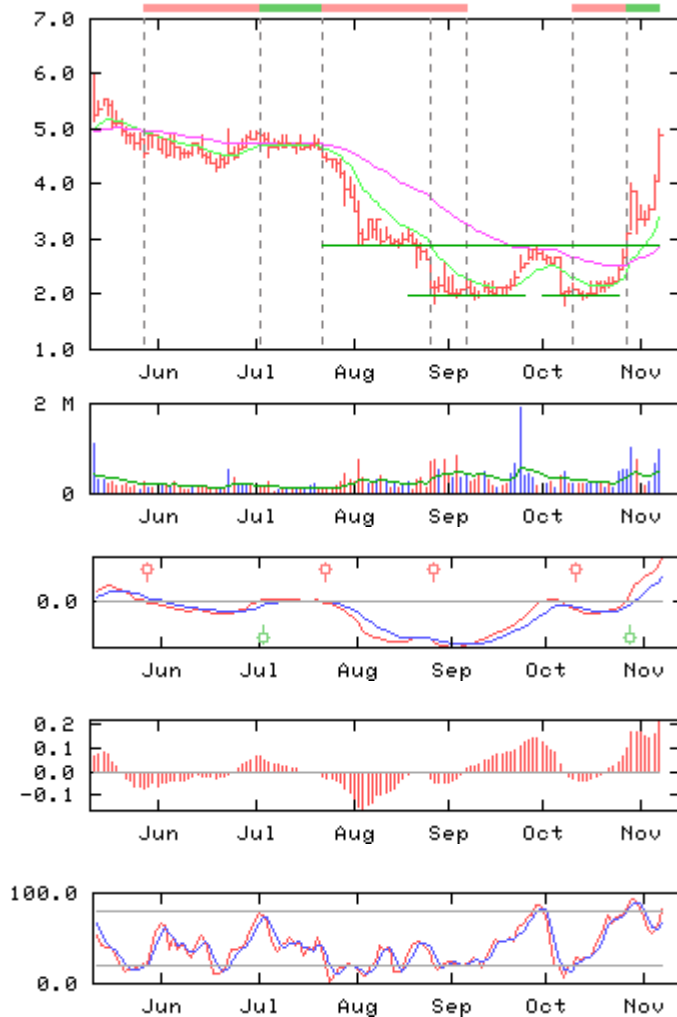
In the price graph of PLP, each high takes prices to a higher price level than the preceding high, and each fade in prices arrests itself at a higher price level than the preceding low.

In addition, volume accelerates when prices are climbing, and shrinks when they drop. This is shown on the volume indicator graph by blue volume bars that stack higher than red volume bars.

In late August, the fade in prices off the early August peak brings prices down to a price level equivalent to the one that marked the prior low in early July. This is ok. As long as prices do not close lower than the preceding low, the stock is still considered to be in an uptrend.

Double Bottom: XOMA by kensey

Xoma Corp (XOMA)



Trade in Xoma Corp (XOMA) is taking a turn for the bullish in the form of heavy buying that is stacking the deck of the volume indicator graph.

A recent double bottom marks the reversal from a long-term downtrend to a budding uptrend. In early September, XOMA bottomed out at 2 dollars a share and skidded horizontally at this price level for a couple of weeks as volume dropped off to near nil. The end of September saw strong buying come in a wave that quickly elevated the stock to 3 dollars a share. Shares then dropped back to 2 dollars a share in early October but this occurred on lower volume. In particular, the selling that brought the stock to 2 dollars a share the second time around was less than the volume that brought the stock to this level the first time around. Volume here was also less than it was during the buying binge that came in between.

The lift-off from the second retest at 2 in mid October marks the exit from the double bottom reversal pattern and the beginning of a new trend.

The requirements for a double bottom chart pattern are:

- Step 1 - The formation of a low
- Step 2 - A lift-off from this low that occurs on higher volume than in step 1.
- Step 3 - A retest of the low made in step 1. The volume in this part of the move is lower than that of steps 1 and 2.
- Step 4 - A lift-off from the second low that occurs on volume that is greater the selling volume in steps 1 and 3.

As you can see, comparing the relative volume in each of these four waves is important. ClearStation graphs help you in this effort by color-coding the volume indicator graph. Up volume is drawn in blue and down volume is drawn in red. So steps 1 through 4 require you only to eyeball the height of each of these four stacks.

In volume terms, the above steps can be boiled down to:

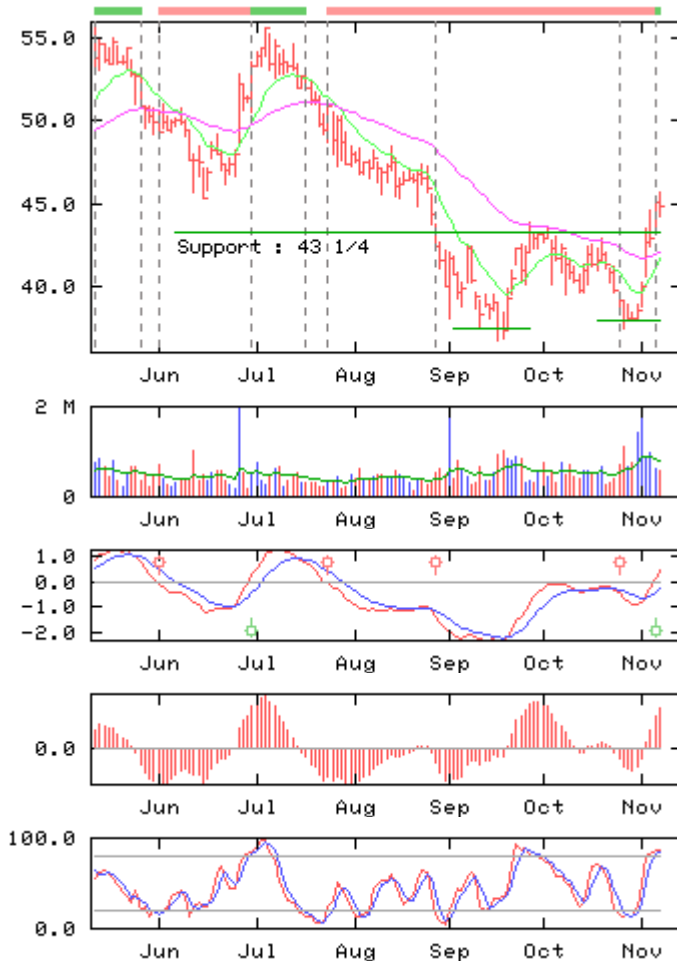
1. Step 1 - big red stack
2. Step 2 - bigger blue stack
3. Step 3 - smallish red stack

4. Step 4 - big blue stack

Even though shares are extended here far above the low at 2, the return to bull trend is the reason to consider them now. Also, shares are lifting off today from a consolidation at 3 and change.

Double Bottom: UK by kensey

Union Carbide (UK)



Trade in Union Carbide (UK) is taking a turn for the bullish in the form of heavy buying that is stacking the deck of the volume indicator graph. This volume is coming as the stock makes an exit from a variation on a classic double bottom.

A double bottom is a reversal pattern (a change in trend depicted on the graph). In this case, the trend has changed from long and persistent downtrend to budding and suggestive uptrend.

Perhaps the facet of the market I liked best in early October was the sight of double bottoms sprinkled all over the ground as drops of sweat was wrung from the brows of fund managers during market retreat stage 2. In the case of Union Carbide it phase-shifted right by a few weeks and so still offers up a trade on the long side if you **love the Chemicals group**.

Prices skidded to 38 in mid September. The end of September saw strong buying come in a wave that quickly elevated the stock to 43 dollars a share. Shares then dropped back to 38 dollars a share in early October, but this occurred on thin volume.

The lift-off from the second retest of 38 at the end of October marks the exit from the double bottom reversal pattern and the beginning of a new trend.

To recap, the requirements for a double bottom chart pattern are:

- Step 1 - The formation of a low
- Step 2 - A lift-off from this low that occurs on higher volume than in step 1.
- Step 3 - A retest of the low made in step 1. The volume in this part of the move is lower than that of steps 1 and 2.
- Step 4 - A lift-off from the second low that occurs on volume that is greater the selling volume in steps 1 and 3 with prices exceeding the high made in step 2.

As you can see, comparing the relative volume in each of these four waves is important. ClearStation graphs help you in this effort by color coding the volume indicator graph. Up volume is drawn in blue and down volume is drawn in red. So steps 1 through 4 require you only to eyeball the height of each of these four stacks.

In volume terms, the above steps can be boiled down to:

1. Step 1 - big red stack
2. Step 2 - bigger blue stack
3. Step 3 - smallish red stack
4. Step 4 - big blue stack

In other action around the world, Natures Bounty (NBTY) looks interesting here. It is in a short-term uptrend and the volume indicator graphs suggests that the downturn from 25 to 5 has run its course.



ClearStation Education: Portfolio Management

Version 2.0
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Portfolio Management

Risk Management

It's key to have a game plan going into the market. A good plan that you can stick to can increase your gains, cut your losses, and ensure that you come out ahead!

This section has some pointers on portfolio management and investment strategies. You should look them over, try them out in theoretical portfolios, and use them to help you develop your own trading strategy.

In this section, you'll learn:

- What to do before **taking a position** in a stock
- About new **investment strategies**

Investing Is Re-Investing by kris

It is about as likely that you will invest well the first time and keep on investing well as it is that you would write a bestseller the first time you ever sat down to write and keep on writing bestsellers. Editing is an important part of writing. For that reason writing instructors have popularized the phrase, "Writing is re-writing." In other words, to write well, you must write once and then constantly improve your draft.

Investing well involves a similar process. The text is your portfolio and editing is the process of selecting, watching, committing to, and abandoning positions. You might say, "Investing is re-investing."

Even with the most expensive and sophisticated tools available, it is still very difficult to consistently make great stock picks. If you are a very good investor, you will probably pick one winner for every ten stocks you choose to monitor. If you are one of the top traders, one out of every five is a winner.

Those numbers don't sound very reassuring do they? So how do the top traders make money while being wrong 90% of the time? Through risk management.

The basic idea is to limit your losses and let your winners run. Let's say every trade you make is a \$10,000 trade. If you pick four stocks and lose 5%, but pick one and make 5%, your net gain will be 4% if you pyramid your successful trade.

When you catch a winning trend, that trend may last for weeks or months. The appreciation on a winning pick can be anywhere from 60% to 200%. Opportunities like these are relatively rare; therefore, when you find one you need to ride it for all it's worth.

So what about the losers? You need to be willing to sell your losers when they hit your risk limits. This approach guarantees losing money on a majority of your trades, but it also optimizes your ability to run with your wins when you find them; it's what's known as a strategy.

Strategy: How and Why by kris

It is difficult to make money in the stock market by acting on tips. Tips are at best unreliable and cannot be counted on for consistent performance. At worst, they are poorly timed and can lose you money. So rather than following someone else's gut feelings, you'll be better off making -- and sticking to -- your own investment guidelines. Developing an original winning strategy that suits your own biases and preferences is the only way to achieve results in the stock market.

Selling a stock at a loss can be an emotionally troubling decision. The only way to do it peacefully is within a strategy that you can grow and groom dispassionately. It may sound absurd, but selling your losses should be performed with as much excitement as closing your winning trades. They must all take place within a well-honed strategy.

How does one acquire such a strategy? Most people just borrow one that appeals to them. However, the trick of any winning strategy is to make it your own.

The Process of Investing by kris

Investing is a relatively simple process:

1. Choose a stock in which to take a position
2. Commit to the position by executing a trade
3. Monitor the trade to see if it fits your expectations
4. Close the trade when your expectations are met or lost

Easy enough, right? So why, then, is it so difficult to get any of these steps right?

Step 1: Stock Selection

The first step in picking a stock is to start watching it. Putting a stock on your Watch List raises your awareness of the stock. It is rare to find a stock of interest and act on it immediately. A good Watch List is the key to successful stock selection.

If you are a technical trader, then price action is your primary motivation for selecting a stock to watch. If you are a fundamental trader, then earnings news or news of any other kind on a company is your motivation. Most investors combine these two disciplines. ClearStation's filtered lists are the most powerful tool you can use to limit the number of issues for further research, since every issue listed shows a compelling reason for action.

Once a stock is on your Watch List, you can compare its performance with that of other stocks you're watching. You can also find other information about that stock, to help you make a decision. Both technical and fundamental traders need more information on an issue before they can move to Step 2, committing to a position.

A technical trader may be more interested in finding additional statistical information on the issue. Has the stock exhibited this kind of price behavior before? What is the stochastic for the stock, the momentum? Is the stock in a strong MACD trend? A fundamental trader will scour news, earnings reports, industry reports, and analysts' reports to find information. As with picking stocks to watch, most people look at a combination of technical and fundamental information when deciding whether to move on a stock.

If even at your very best you are only going to pick one good stock out of ten, your Watch List should be a compilation of your best losers. Only your best winners will make it to your portfolio. That is, only the best of your Watch List will make it to Step 2.

Step 2: Commit to a Position

Committing to a position is fairly straightforward: You contact your broker and execute the trade. However, there are several considerations.

First there is the side of the trade you wish to go on: long or short. Though the general tendency of stock prices is to go up, anyone who has made a losing position can tell you that in the short run, stocks are just as likely to go down.

In general, I stay away from short positions. They just take too much work. There are very few genuine short-side opportunities. And, if you take one, you need to monitor it twice as carefully as your long positions.

However, there is no reason not to take a short when you see it and it's in line with your overall strategy. Shorting in times of overall market uncertainty can yield significant gains. (ClearStation is the only Web-based portfolio manager that enables you to monitor both short and long positions with equal ease.)

Next there is timing. Many investors only execute on retrenchments. This means that they are convinced that a stock is trending and want to join the bulls or bears. However, they can't make a commitment until there is an opportunity. On a stock that is trending up, some may choose to wait until a down day, or the n th down day, before getting in. Others may wait for technical signals, such as stochastic, to make a commitment.

Finally there is your choice of broker. If you are an individual investor you probably use a discount service. After all, why pay for a service that you don't use?

If you want to share your decision with a financial advisor, spouse, or investment club, ClearStation makes it easy through its "recommend portfolio" subscription service. Any ClearStation member can subscribe to your recommend portfolio and receive an email notification as soon as you've decided to commit to your position.

Step 3: Monitoring the Position

Monitoring your committed positions is the most critical aspect of the trading process. All of the information and investigation that went into your strategy and got you to pull the trigger in the first place is now put to the test: if you went long, are you finding more bulls by your side? If you went short, are you finding more bears?

Failing to monitor your positions can mean drifting into waters you never intended to enter. It can mean ending up with less at the end of the day, not more.

ClearStation enables you to monitor your positions in several ways, including their day-to-day fluctuations, whether they are going into or out of trends, the strength of those trends, whether other technical signals are being flashed, and what the investment community thinks of your picks. When your neck is on the line, it is important to pay attention to all of these items.

If you went long and your pick is going up, it is important to consider pyramiding up. If your long pick is going down, you have to know when to cut your losses.

When you do not get signals to reinforce your decision, get out early and often. However, when you do get these signals, you need to increase your position to increase your gains.

Getting in and out of positions costs less than it does to park your car. With so little to gain and so much to lose, it's hard to understand why some traders are afraid to sell as they lose 10%, then 15%, 20%, or even more on a bad call.

Step 4: Closing the Position

If you picked a loser, you are already out. However, many investors do not know when and how to close a winning position. Paper profits can't buy you a new house or car. To make money in the stock market, you have to close the trade.

If you increased your position size as the stock went up, you may want to close the position in the same way, especially if the trend is not clearly showing signals of an end. Taking a few shares out to cement a profit is a good idea. However, you need to continue to monitor the issue so that you don't miss out on a continuing trend.

Pyramiding by kris

I only make strong commitments to stocks that give me a lot of positive feedback. As a winning decision is confirmed, I double up or add even more to my position. That is, I pyramid up. The process of pyramiding up is one of the oldest and most successful strategies in investing.

For example, if I take a 100-share position at \$12 in a stock that I believe is trending up, and that stock goes to \$14, I have received my first confirmation of that trend. I add 100 shares to that position. Over the course of weeks, as the stock reaches subsequent price points, I add another 200, and so on. Say I have a total of 1,000 shares committed to this position and I notice some weakness in the trend, I start closing out just as carefully as I got in.

Pyramiding down is the hallmark of a losing investor. An investor with no risk management strategy who buys a stock at \$12 and sees it go to \$10 will think, "I thought it was a good buy at \$12, it must be a steal at \$10!"

However, this losing psychology has nothing to do with investment principals. Buying stocks is much different from buying any other type of item. In fact, there is no inherent value to a stock outside of the price the general public is willing to pay for it. Every stock can go to a value of zero.

A winning position is much like a precious crop whose value you must nurture by tending it.

More on Pyramiding by kris

Pyramiding is the process of easing into and out of positions. In a perfect world, we would always pick the stocks that are moving the quickest, throw everything we have at them and exit at exactly the right moment. However, in the real world we must be more cautious.

Pyramiding allows you to move into those positions that allow you time to confirm a stock's prevailing trend.

Let's say that you have \$10,000 to spend on a stock that costs \$10 a share.

Pyramiding into the stock would mean buying only 100 shares on day one. As time goes by and you see confirmation of an upward trend (that is, it goes to \$11 and \$12), you add to your position, first by doubling up (an additional 100 shares) and then doubling that position (now at 400).

On some stocks like CSCO and MSFT, this process can go on for years, provided that you have the financial resources to increase your investments.

Eventually, the trend ends. Pyramiding out means closing positions just as cautiously as you got in.

Using pyramiding, you allow your winners to run and you limit your losses right up front. Also, there are as many variations on this technique as there are investors. Some people will double up while others triple up or more. Some investors will add fractional amounts.

Even best stock pickers are often wrong about individual stock selections. Their portfolios exhibit superior performance because they cut their losses early and they let their winners run. I never lose more than 10%. That's my personal parameter. If a stock goes from 10 to 9, I sell it regardless of how well I think it will perform in the long term.

Those are just my numbers. You'll find yours.

Opportunity Management by kris

Opportunity management is the process of maximizing your gains. A necessary complement to the process of minimizing risk, it should form an important part of your overall investment strategy.

We are in an ever-increasing market where the choice is not between making or losing money, but between getting average or superior performance. Why should you be happy with 10% or 20% gains when the broad averages are doubling that? Successful opportunity management enables you to get in on the fat side of a trend and get out when an even bigger trend comes your way.

There are several effective steps you can take to find and jump on opportunities. These include tending your Watch List, scaling your holdings, setting stops, and making a tracking portfolio.

How to Go About It

Nothing creates more personal investing opportunities than a well-fed, well-trimmed Watch List. Every day you should endeavor to add issues of interest to your list. The best source for your Watch List is ClearStation's filtered lists of issues that are exhibiting excellent price action.

Scale holdings with net worth: The more holdings you have, the more your gains and losses will mirror the major market averages. Limit your holdings to the amount that does not move the stock price itself.

Setting stops and tracking are advanced investing tactics that can significantly boost your investing performance and hone your strategy.

Monitoring issues in your portfolio will tell you if an issue has confirmed your decision. Placing stops automatically limits the damage that can occur when you have made a bad call.

A stop is an order that can be placed with your broker that will automatically execute a trade when a certain price limit has been met. Setting stops, though a very good idea, can be dangerous for highly volatile issues. For example, if the trading range of the same \$10 stock was \$9-11, a stop at \$9 would close you out on ordinary volatility, which tells you nothing about the trend and more or less guarantees a loss. Don't do that. Only place a stop outside of the reasonable volatility of that stock. If you are comfortable trading highly volatile stocks, don't place stops unless you are going on vacation.

In addition to the Watch List, a tracking portfolio can be instrumental in managing opportunities. A tracking portfolio monitors the positions you are pyramiding up: the most successful positions in your investing strategy.

When I create an initial position, I add it to my main portfolio. When it exceeds 10%, I start pyramiding up. When the trade confirmation comes in, I add the position to my tracking portfolio at the new, higher price. If I pyramid up again, I close the position in the tracking portfolio and add it again at the new rate.

The tracking portfolio tells me when the trend is losing steam. It tells me when it's time for my favorite activity: closing winning positions.

Wall Street Myths by kris

There is a very well-developed mythology that surrounds trading in the stock market. Among the greatest and most damaging myths are

- Myth #1: The Wall Street insiders and professionals have an advantage.
- Myth #2: The real money-makers day trade.

While there certainly was a time when the first myth had some truth, the second is at best misleading. At worst, it is one of the most damaging misconceptions for individual investors to have.

With the advent of the Internet, there is very little information that remains accessible only to the professionals trading on Wall Street brokerage accounts. Though there is a lot of attention paid to analysts who receive early access to company news, their profits are severely limited due to Myth #2.

It is difficult for me to understand sometimes what exactly day traders are doing. They have simply picked another job for themselves, and like any good employee, they are trying to look busy.

The only trends worth following in investing are those that yield returns of 50-500%. Trends like these, though rare, are constantly occurring in the market. They never occur on a daily or hourly basis, but yield their gains in the week-to-month timeframe.

ClearStation finds stocks that are performing in this critical timeframe. By using MACD and stochastic primarily, we cut out the noise of the market to present only a handful of issues every day that are entering week-to-month trending performance.



ClearStation Education: Trading Basics

Version 2.0
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Trading Basics

Trading 101

Do you feel cheated because, while everyone around you learned everything they needed to know in kindergarten, you missed out and need help getting started in the stock market? Never fear! You've found a great place to start.

In this section, you'll learn:

- What **stock** and **price** are
- About **long** and **short** positions
- About **exchanges**
- What to take into consideration when picking a **broker**
- What **splits** are and why they happen

Lock, Stock and Barrel by kathia

Let's say that your nephew Fritz has started a company. Because it sounds really promising, you decide you'd like to give him some money so that he can get things rolling. In return, he gives you a piece of paper that says you are a part-owner, entitled to a portion of the company's earnings and assets as well as voting rights in the election of directors.

Though this example is a bit simplistic, it describes fairly accurately what stock is. Here's a more in-depth explanation:

Every corporation is worth a specific amount of money (the value). This value is typically set at the highest price a buyer would pay for the company that the seller would be willing to accept. The value is then divided into separate equity units called shares. Anyone who owns a share owns, in essence, a small part of the corporation—with all the perks of having voting rights and being entitled to a portion of the company's earnings. To own shares in a company is to own that company's stock. As the company increases in value, the value (or price) of each share also increases.

Once a company has gone public, almost anyone can buy stock in it. (To "go public" means that the corporation went from being privately funded to trading openly on the market so that anyone can invest in it.) The word "stock" has several aliases you should be aware of—a stock can also be referred to as "a security" or "an issue."

There are different **classes** of stocks. What was described above is the most common type of stock—**common stock**. Logical, no? **Preferred stock** is another class. With preferred stock you do not get voting rights, however you are entitled to receive your take of the dividends (the distribution of earnings) before people who own common stock can get any.

Sometimes a company will split its stock into different classes of common stock—Class A and Class B common stocks, for example. They can differ in a number of ways usually specified by the issuing company, but the most typical is one class getting more voting rights than the other. It can also involve a difference in dividend or liquidation privileges.

Exchanges by kathia

Billions of shares of stocks are traded every day—ever wonder where it all happens?

Stocks are traded on **exchanges**. An exchange can be classified as either a "securities and commodities exchange" or "over the counter." What that means is that the exchange is subject to the rules and guidelines of its governing body.

The securities and commodities exchanges are organized, national entities where securities, commodities (bulk items like food and metals), futures contracts, and options are traded. Members of these exchanges handle the trades for themselves and their clients. Know those scenes you see in movies where people wearing funny coats are running all over the place frantically trading stocks? Chances are they are representing these exchanges.

Securities and options are regulated by the SEC (Securities and Exchange Commission) while commodities are governed by the Commodity Futures Trading Commission. The New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) are grouped here. Other exchanges include the Chicago Options Exchange (CBOE), the Philadelphia Stock Exchange, and the Pacific Stock Exchange to name a few.

For the over-the-counter market, trades are handled electronically—either via telephone or computer. The over-the-counter (OTC) stocks usually belong to smaller companies that were not able to meet the strict requirements of the NYSE or AMEX. Sometimes companies go with OTC just because they prefer the way things work: there are many dealers who can execute trades whereas on the securities and commodities exchanges trades for a stock would have to go through the specialist that handles that particular stock. Regulated by the National Association of Securities Dealers, NASDAQ provides the automated quotes for this market.

As a final note, OTC Bulletin Board stocks (OTCBB or simply BB) are stocks that trade over-the-counter but do not have a high enough value to trade on NASDAQ. They are also known as penny stocks.

Let's Make a Deal by kathia

The stock market is much like a street bazaar in Mexico. You go to the market, cash in hand, intent on buying a specific item. You check it out pretending you're not that interested in buying it, when really you're as excited as a kid in a candy store.

The owner looks you over and decides you have money—he tells you he'll give you the velvet Elvis at a bargain! The price he will sell it to you at is his **asking price**.

You snort. There's no way you will pay that much for Elvis. You make an offer. That's your **bidding price**—what you will consider buying it for.

If the two of you come to an agreement you have a deal! The actual **price** of the item is the consensus you and the owner reached—what you were willing to pay for it and what he was willing to sell it for.

Stocks work in much the same way. You have a bidding and an asking price. The bid is what a buyer offers to pay for a share of stock. The asking price is what a seller will accept to part with a share of stock. (Incidentally, the difference between the bid and ask is called the **spread**.)

The bid and ask prices largely depend on supply and demand. High demand or low supply will push the prices of stocks up, while little to no demand or a large supply will cause the price to fall.

Splits by kathia

Every so often you'll see a **split** announced for a stock you have an interest in. When a stock splits, the number of shares is multiplied but the total value remains the same. For example, if a stock splits 2-1, the number of shares doubles. So if a company had one million shares valued at one dollar per share, after the split there would be two million shares at a value of 50 cents per share.

Let's say one of the stocks in your portfolio has announced a 4-1 split. If you own 100 shares of the stock at 10 dollars a share, once the split takes place you'll have 400 shares at 2.50 dollars a share. See how it works?

The purpose of a split is to lower the price of a stock, making it more accessible to the general population. It's the directors of a company that make this decision. If you see a stock in the 200 dollar range, count on a split happening in the near future.

Reverse splits are possible as well though not as common as regular splits. In a reverse split, the number of outstanding shares decreases but the value still remains the same. So if there were a 2-1 reverse split for a company that had two million shares at 10 dollars a share, afterwards there would be a total of one million shares at 20 dollars for each share. A company would authorize a reverse split if they wanted to increase the price of their stock to attract more investors.

Bulls, Bears, and Sheep by kathia

Basically, there are two types of people who trade: buyers (also known as bulls) and sellers (or bears).

Buyers are optimists. They buy stocks because they believe the prices will rise, increasing their profit. Sellers are pessimists—they act on the belief that prices are going to fall.

There is a spectrum of trading styles: from day traders to buy and hold, and everything in between. Day traders are actively engaged in the market. They may buy and sell the same stock several times in one day, each time making a minute profit. Day trading is definitely not for everyone: it requires constant vigilance over your portfolio and the willingness to devote all of the trading day to it.

People who buy and hold pick stocks that they believe will make good long-term investments. They get into the stock for the long haul and are not concerned with short-term price fluctuation. Once again, this is not for everyone: you have to be willing to leave your money tied up and it can be nerve-wracking to ride your stock through price declines.

There is a happy medium: it's whatever style works best for you. Experiment to find what you are comfortable with; experience will teach you where your strengths lie.

The Long and Short of It by kathia

When you make a decision to act upon a stock, you are **taking a position**.

There are two kinds of positions you can take - a long or a short position. Taking a **long position** means buying the stock based on the belief that the price will rise. A buyer would take a long—or bullish—position.

The **short position** is a little more complicated. The idea behind shorting is that you sell the stocks and then buy them when the price falls, earning you a profit. Sounds odd, doesn't it? Here is how it works:

You decide that the price of a certain stock is going to fall. You call your broker and put in an order to short, "selling" the stocks at the current price.

Your broker rounds up the shares in order to sell them for you - he either loans you the certificates from his stash, from the account of one of his other clients, or borrows them from another broker. Then, when the price falls, you buy the shares at the lower price, covering the number of shares that were borrowed.

Choosing a Brokerage by kathia

In order to trade stocks, you need to have an account with a **brokerage**. A brokerage is a business with minions called brokers who handle the actual buying and selling of shares for you. There are two different kinds of brokerages: full service and discount.

A full service brokerage offers a wide range of services. Your broker will provide you with investment ideas in addition to doing the research you will need to make decisions. (Since brokers typically earn a commission on each trade their clients order, they often do a bit of soliciting.) Other perks they offer include annuities, insurance, and so forth. Because of all the extras that full service brokerages offer, they can be fairly costly to use.

A discount brokerage offers bare-bone trading options for a fraction of what you would pay at a full service brokerage. The types of services offered vary according to the brokerage. The brokers at discount houses only execute your trades. They neither solicit nor offer you investment ideas—you're pretty much on your own. Nowadays, most discount brokerages have online services for added convenience.

The kind of brokerage you choose depends completely on the kind of services you are looking for. The first thing to do is decide what you need. What kind of trades will you be making? How often will you be trading? How much guidance will you require? What kind of customer service do you want available to you? Will you want to call in your trades over the phone? After you have an idea what your basic needs are, start researching brokerages which meet your basic requirements.

For a listing and rating of online brokerages, including types of services offered, check out [Gomez Advisors](#).



ClearStation Education: Mr. Tax Man

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Mr. Tax Man

So you made a bundle in the market this year, huh? Have you thought about the tax consequences? They can make a BIG difference come April. Best to plan now. . .

Let marc, ClearStation's own tax man, teach you about the tax laws that affect traders and investors, which kind of IRA is best for you, and the basics of capital gains. He'll also help you understand the wash sale rule and the tax implications of incentive stock options.

In this section, you'll learn:

- Whether the IRS considers you a trader;
- What incentive stock options mean to your bottom line;
- The difference between traditional and Roth IRA's;
- How wash sales work;
- How best to prepare to meet with your tax expert.

Trader or Investor? by marc

The growth in day trading has had a profound impact in how certain individuals file their tax returns. Active traders, who engage in a great deal of short-term trading, may have a chance to qualify for a preferred filing status with the IRS. Most taxpayers fall into the default filing status of "investor" when they file their tax returns. However, if you spend your days buying and selling stocks like a hedge fund manager, you may want to consider filing your tax return as a "trader". Doing so could result in substantial savings at tax time, **but** you might also be exposed to increased audit risk.

So what are you, a trader or an investor? It's an important distinction, yet there's considerable ambiguity surrounding the trader status. In tax terminology a trader is someone who trades to catch short-term swings in the stock market (not long-term appreciation or dividends and interest), and does so in large enough volume, consistently over a long enough period of time. This "definition" does not do a good job in clarifying what a trader is, and it actually produces more questions; what constitutes "large enough volume" and "long enough period"?

Unfortunately, not even the IRS has established clear guidelines to answer those questions. All you have on which to base your decision are guidelines developed through court decisions dating back more than fifty years. As a matter of fact, it wasn't until the Taxpayers' Relief Act of 1997 that the IRS even addressed the issue of day trading.

Why doesn't the IRS specifically address the issue? I've read some interesting literature about the subject and the general consensus seems to be that it's not in the IRS's best interest to clarify the law. Doing so would facilitate taxpayers' efforts to reduce their taxes, which is counterproductive to the IRS's mission in life.

What are the Tax Benefits?

The IRS considers investing a hobby. It limits the losses you can take on a given year and the expenses you can deduct from the activity. As a side comment I think it's funny that it doesn't place any limits on how much of your investment earnings it can tax! No wonder we've a got budget surplus, but that's another topic.

Trading is considered a business, eligible for tax "write-off's" not available to investors and 100% deduction of legitimate business expenses, such as newsletter subscriptions, a home office, and computer equipment.

Traders are further entitled to elect a special method of accounting called "mark-to-market". This method wipes out the \$3,000 capital loss limitation and eliminates the despicable "wash sale" rule. I'll go into more detail about mark-to-market further along this article. What are the Disadvantages?

I can just see the wheels turning in your Clearhead right now. You're probably thinking, "sounds like a cool deal, where do I sign up for this trader thing?" But before you start making plans to file as a trader, you'll need to consider the disadvantages. What disadvantages you may ask? How about is the increased risk of audit?

As we discussed earlier, there are no clear definitions or standards for determining whether or not you are a trader. If you take an aggressive stance and file as a trader and later the IRS decides that you are not, you may end up with a hefty tax liability, and penalties plus interest on top of it!

Another disadvantage is if you elect mark-to-market method of accounting, you have to pick up your trade earnings as ordinary income, not capital gain. You further have to report, at year-end, your earnings from all stocks, sold or **not!**

Another disadvantage, and this is a big one, is that there are a lot of tax professionals out there who are unfamiliar with trader status. Couple that with the amount of misinformation that's currently floating around (some of it from our friends at IRS) and there's a real potential for disaster. I'm not trying to dissuade anyone from pursuing what he or she are entitled to, but I am emphatic about encouraging you to exercise a great deal of caution in this area.

With that said, let's discuss how you would file for trader status.

Am I a Trader?

The courts say you are a trader if the following elements are met:

1. The trading has to be geared to take advantage of short-term market price swings. Traders are typically not concerned with the long-term prospects of the companies they trade. They don't care about a company's balance sheet or income statement, and generally disregard any sort of fundamental analysis. The holding period is critical because the courts have given it considerable weight to determine whether one is or is not a trader. If securities are held for months instead of days, the courts assume that the individual is an investor instead of a trader, looking to capitalize on long-term appreciation, or to produce a significant amount of dividend or investment income.
2. The trading is "substantial." The trading has to occur frequently and over a long enough period of time. What qualifies as "frequent"? The answer to this question is not readily available, but the Supreme Court has stated that the taxpayer must be "involved in the activity with continuity and regularity." The basic assumption that can be drawn is that a trader would be trading with a number of transactions each day. Of course, that leads to the question of how many daily trades must be executed to qualify as a trader? According to Kaye Thomas, a tax attorney who's an authority on the subject, the courts should "look at whether the activity was carried on the way someone would if they treated it as a serious business. If you have a good business reason for executing only a few trades, or none at all, for a period of time, then your absence from the market should not disqualify you from trader status." Makes sense to me.
3. You must trade for your own account and you must do the trading yourself. If you sell securities to customers, you're a dealer, not a trader.
4. Trading must be your primary business, not a hobby or something you do on your spare time. You must meet all of the above criteria to qualify as a trader, and even then there could be questions. Check out the details and if you're still not sure you meet the requirements, seek the advice of a knowledgeable professional.

Yeah, I'm a Trader...Now How do I File? Once you've done the homework, and concluded that you satisfy the requirements to file as a trader, you should prepare your return as follows:

1. Report your gains and losses on Schedule D. You will still be limited to \$3,000 in net capital losses and will be subject to the wash sale rule, if you have not made the mark-to-market election (more on that later).
2. Report all your expenses from your trading business on Schedule C like any other sole proprietor. These include your books, seminars, reference materials, and margin account interest. You can also deduct expenses relative to your home office and probably take an immediate deduction of up to \$19,000 for equipment and furniture used in your business (called a Section 179 Deduction).
3. Your Schedule C will reflect a net loss that gets carried to line 12 on Form 1040, and serves to reduce your ordinary income and gains from capital transactions.
4. It's important to note that although traders file a Schedule C for their trade or business, they are not subject to self-employment tax because capital gains are exempted. Pretty nice deal, huh?

All this makes for a funky-looking tax return. Schedule C will have expenses and no income, while your earnings from trading end up on the Schedule D. I can just imagine some IRS auditor in Fargo looking at a trader return and crying out "Golly, geez! What the heck do you mean?" Yet, this is the right way to do it.

Finally, Mark-to-Market!

If you qualify as a trader, the IRS allows you to make the mark-to-market election. Yes folks, this is an election, meaning you don't automatically get mark-to-market treatment when you become a trader.

The election must be made by the tax return filing deadline for the year before the year for which you want the election to be effective, excluding extensions. "Golly, geez! What the heck do you mean?" For example, if you want you election to be effective for the year 2000, you must elect by April 17, 2000.

So what does mark-to-market do for you? Well, under normal circumstances, when you sell a security at a loss, you can deduct that loss from your trading gains. But if you buy the same security within 30 days, before or after the sale, the IRS considers the transaction a "wash sale", and the loss deduction is disallowed.

By electing mark-to-market method of accounting, you will automatically become exempt from the wash sale rule. The way it works is on the last trading day of the year you treat any stocks you hold as if you sold them. Even though you still hold the stocks, you book the gains and losses as of that day for tax purposes. You then begin the new tax year with no unrealized gains or losses, and the basis for the stock is adjusted as if you had bought back all the shares you "sold". The logic here is: if all your gains and losses are going to disappear after year-end, then there's no reason for the IRS to be concerned about wash sales that may occur during the year.

Another advantage of mark-to-market method of accounting is your trading gains and losses are converted to ordinary income and loss. This change in character allows mark-to-market traders to deduct an unlimited amount of losses, which can be of great benefit in a loser year. You'd report your gains and losses on Schedule C, not Schedule D. But don't worry - this ordinary income and loss treatment does not apply for purposes of self-employment tax.

The one downside to mark-to-market election is that you will never have any long-term capital gains. But being a trader you should not have any, so this aspect of the election is of no significance. To quote an enlightened Clearhead trader, "an investment is a trade gone bad."

Identifying Your Holdings:

Before you make your mark-to-market election, you need to identify which of your holdings are investments. Failing to do so could be disastrous.

Imagine you're a mark-to-market trader and you own Microsoft stock that you've held since the late 80's. Can you see it coming...? If these stocks are considered to be a part of your trading business, you will have to mark them to market at the end of the year and pick up the gain as ordinary income. This is what I mean by disaster.

The mark-to-market rules permit you to identify such investment holdings and take them out of the picture to prevent something like the above scenario from happening to you. You make this identification when you make your mark-to-market election.

The Treasury Department has not yet finalized regulations that address the identification issue, but there exist proposed regulations. According to Kaye Thomas, here's what the proposed regulations say:

1. If you make the mark-to-market election, you must identify any securities held other than in connection with your trading business.

2. Your identification isn't effective unless you can demonstrate by clear and convincing evidence that the securities have no connection to your trading business.

Side note: Point 2 is crucial! It effectively states that the IRS can disregard your identification if you haven't shown by "clear and convincing evidence" that the security has "no connection" to your business. I'll tell you how to minimize the chance of that happening a little further down.

3. If you hold an investment security and also trade the same security, or substantially similar securities, your identification isn't effective unless you hold the investment securities in a separate non-trading account maintained with a third party.

Point 3 tells you how to avoid having your investments declared as part of your trading business. Establish separate accounts for investing and for trading and DON'T MIX THE TWO!

Mark-to-Market Election:

Once you've 1) determined that you are a trader and 2) identified your investment holdings, you are ready to make the mark-to-market election.

As discussed, the election has to be made by the unextended filing deadline for the previous year's return. You want to be a mark-to-market trader in 2000? Elect by April 17, 2000. That's the easy part.

The election must be attached to your tax return or extension. According to Kaye Thomas, your election statements should look like this:

John Q. Taxpayer
SSN 555-55-5555
Attachment to 1999 Form 1040 (or Form 4868 if you are extending)

I hereby elect to use the mark-to-market method of accounting under section 475(f) of the Internal Revenue Code for my trade or business or trading securities. The first year for which the election is effective is the taxable year beginning January 1, 2000.

John Q. Taxpayer

BIG NOTE: When you file your tax return for the effective year of your election (in our example that would be your 2000 tax return), you must attach Form 3115, Application for Change in Accounting Method. This is a lengthy, pain in the rear form that just reeks of bureaucratic red tape. But you have to file it. The good news is only the first three pages of the eight-page document apply to mark-to-market traders. Once you've filed Form 3115 you won't have to do it again, unless you decide to change accounting method later.

That's it. I hope this has been informative, because I know it sure as hell ain't fun. Happy trading y'all!

Incentive Stock Options by marc

So "Who Wants to be an ISO Millionaire?" I see Bill Gates, Steve Jobs, or Steve Case as potential game show hosts and the contestants are hotshot software engineers who get asked interview-type questions, with the winner receiving Incentive Stock Options worth millions when they become exercisable.

When you think about it, that's not so far off from how it works in the real world. As I've heard over and over, ISO's are the equivalent of a present day Gold Rush. "Forget salaries...I want my stock options!" is the new Silicon Valley battle cry. But do ISO's deserve all the hype they've been getting? Or are they in truth the "fool's gold" of the new millennium? Let's start by briefly discussing the ISO process and then we'll move on to tax ramifications.

More and more employers are giving their employees stock options as part of their compensation package. In simplest terms an option is the right to buy (or in more complex options, the right to sell) a certain number of shares of a company for a specific price by a specific date. The difference between the "strike price" ("exercise price" in tax terms) and the fair market value (FMV) of the stock is the "spread" ("bargain element" in tax terms). If the spread exceeds the cost of exercising the option, then the option is in the money.

I.E.: You pay \$10 for the rights to purchase one share of stock at \$25 a share for 24 months. If during the option period the FMV of the stock climbs above \$35 a share, you are "in the money".

Stock options basically come in two varieties:

1. **Statutory options:** These are stock options that meet Internal Revenue provisions 421 through 424 and are also commonly referred to as incentive stock options, ISO's and qualified options.
2. **Nonstatutory options:** These are all other options.

Statutory options consist of:

1. Incentive Stock Options (ISO) and
2. Options granted under Employee Stock Purchase Plans

Incentive stock options are the most popular stock option plan. ISO's are granted in connection with employment and can have regular tax and alternative minimum tax (AMT) implications. We'll address AMT in more detail further along this article. The mere receipt of an ISO is not a taxable event; however, there are tax consequences that arise from the exercise and sale of ISO shares.

When you exercise your ISO, the difference between the FMV over the option price on the date of exercise (the spread) will increase alternative minimum taxable income (AMTI), which may trigger AMT. This is not a big deal if you don't owe AMT in the year of exercise, but if you do, your AMT bill will be higher. As a consolation, you may qualify for an AMT credit that can be used in subsequent years when your regular tax is higher than you AMT.

After exercise, the next taxable event occurs when the ISO shares are sold, and is based on (1) profit and (2) period of time the stock was owned prior to the sale. This is an area where good tax advice comes in handy. Here's why:

Profit (gain in tax terms) is the difference in sale price and the FMV on the date of exercise. How long you owned the stock (holding period) determines if your profit is subject to long-term capital gain (LTCG) or ordinary income tax. The new maximum LTCG rate is 20% as opposed to the maximum ordinary income tax rate of 39.6%. In essence, poor planning can potentially cost you twice as much in tax!

The favorable LTCG rate applies only if the stock is held for at least (1) two years after the option was granted and (2) one year after exercising the option. In addition, to qualify for LTCG rate on sale of stock,

the employee must be an employee of the Optionor at the time of the exercise, or have terminated employment not more than three months before exercise.

Example:

If you received ISO's on 12/31/99, you would have to wait until the following dates to receive LTCG treatment:

Date ISO received	Date of Exercise (on or before)	Date of Stock Sale LTCG Treatment (on or after)
12/31/99	12/31/00	12/31/01

Employee stock purchase plans are written plans approved by shareholders that give employees the option to purchase stock of parent or subsidiary companies, usually using payroll deductions to pay for the shares. Purchase plan options are stock option plans primarily intended for rank and file employees (unlike incentive stock options, which are primarily intended for key employees).

To receive favorable (LTCG) tax treatment, the employee stock purchase plan must meet certain requirements.

1. The exercise price of the options granted under a stock purchase plan must be no less than 85% of the stock's fair market value at the time the option is granted.
2. Upon the sale of the stock, the gain is treated as LTCG if (1) the sale occurs not less than two years after the option was granted and (2) one year after exercising the option.
3. The option must be exercised within 27 months of receipt or 5 years if the option price is at least 85% of the stock FMV at the date of exercise.
4. No employee can acquire the right to buy more than \$25,000 of stock per year at the time the option is granted.

How does exercise trigger AMT?

As I mentioned earlier, the ISO spread on the exercise date goes untaxed for regular income tax purposes but does get picked up for AMT purposes as a "positive adjustment." "Positive" for Uncle Sam but definitely not for the taxpayer! Here's an example:

You elected to exercise your option to buy 1000 shares of your company's stock at \$100/share when the FMV of the stock was \$150/share.

FMV of stock at exercise (1000 sh @ \$150/sh)	\$150,000.00
Less ISO price (1000 sh @ \$100/sh)	<u>(\$100,000.00)</u>
AMT positive adjustment	\$50,000.00

The AMT adjustment is reported on the "incentive stock options line" of IRS Form 6251.

I found a neat shorthand method to avoid the AMT if you plan to exercise. This is a calculation you have to do **before** you exercise. Let's consider the following scenario:

1. You calculated your regular income tax on Form 1040 to be \$50,000.
2. Your separate AMT tentative tax calculated on Form 6251 is \$40,000.
3. Subtract the difference

4. Divide the difference by the AMT rate of 26%. This calculation will tell you how much additional AMTI you can have before triggering AMT.
5. Divide this number by the spread per share from our previous example (\$50,000/1000 shares = \$50/share)
6. The result is the maximum number of shares you can exercise before triggering AMT.

Let's do the math:

Regular Tax (Form 1040)	\$50,000
AMT (Form 6251)	\$40,000
Difference	\$10,000
Divide by AMT Rate (26%)	\$38,462
Divide by Spread per share	\$50
Maximum shares that may be exercised without AMT	769

Nonstatutory stock options, also known as non-qualified stock options (NQSO), do not meet the requirements of, and are not bound by, the rules of IRS Code Sections 421 through 424. I know I previously referenced these code sections, and you may have wondered "What do these sections say?"

In broadest and most basic terms, IRS Code Sections 421 through 424 make it so under very specific rules, the recipient of **statutory stock options** may:

1. Defer income recognition on the spread until sale of the stock.
2. Receive total capital gain treatment.

The recipient of an NQSO is not allowed that. Instead, the spread is taxable as compensation (ordinary income) in the year of exercise. However, if the FMV of the option is "readily ascertainable" when the option is granted, income will be recognized then. If the stock is expected to increase substantially in value, this could be advantageous to the employee.

Unsurprisingly, the IRS has strict guidelines relative to when an option has a "readily ascertainable" FMV. Here's a breakdown:

1. The option may be transferred freely.
2. The option is exercisable immediately in full.
3. There are no restrictions on the option or stock that impact FMV of either.
4. The value of the property subject to the option, the probability of an increase or decrease in value, and the length of the option period determines the FMV of the option.

But what if restrictions exist which prevent you from being able to readily ascertain the FMV of your option? The IRS does provide a relief mechanism for this situation, known as Code Section 83(b).

Code Section 83(b) allows you to elect immediate taxation on the option, instead of waiting until the restrictions have lapsed and/or you're fully vested.

This election may at first seem odd, since you'll have to pay ordinary income tax on the spread **BUT** an 83(b) ensures that any future appreciation is not compensation and begins the holding period for LTCG treatment when you sell the stock.

What's more, you then own the option and your basis included the exercise price **PLUS** the amount you picked up as income by virtue of the 83(b).

Consult your tax pro before accepting or exercising any stock options. Doing so may mean the difference between hitting pay dirt or just hitting the dirt.

IRAs: Traditional or Roth? by marc

In August of 1997, President Clinton signed into law the Taxpayer Relief Act. This wonderful piece of legislation provided many new benefits to taxpayers, including a new vehicle for retirement savings called the Roth IRA.

Named for its sponsor, Senator William Roth from Delaware, the Roth IRA offers relaxed rules for eligibility, contributions, and distributions. But the real attraction of the Roth is that your earnings grow tax-free! That's right folks, when it comes time to break into the Roth piggy bank your withdrawals, provided you complied with certain rules, will not be taxed.

Before getting into the details of the Roth IRA however, let's understand that all retirement accounts have a three-step cycle. (1) Treatment for contributions i.e. money going "in", (2) Treatment during the Growth/Accumulation Phase, (3) treatment for money going "out", i.e. distributions.

Contributions: Contributions to your traditional retirement plans, which includes 401(K)'s, personal IRA's, SEP's and Keogh's, are all tax deductible. That is, the contribution that you make into these accounts generates a tax deduction on your personal tax return.

In contrast, the Roth does not generate any tax deduction for your contribution.

Growth/Accumulation Phase: All retirement accounts are identical during the growth phase in that any income generated from the assets is not subject to income tax.

Distributions: Distributions from your traditional retirement plans are taxable to the recipient as ordinary income. Distributions out of a Roth are totally tax-free to the recipient! Let's repeat that. Any monies taken out of a traditional IRA, SEP, Keogh, 401(K) are taxed to the recipient as ordinary income versus your Roth distribution, where amounts taken out are totally exempt from income taxation.

Here are some of the specific rules regarding Roth IRA's.

You can contribute up to \$2000 per year to a Roth IRA account. But, unlike its cousin the Traditional IRA (which we'll talk more about later), you get no tax deduction for your contribution.

Roth IRA Distributions: To take distributions from a Roth IRA totally tax-free, you must meet two basic requirements. First, you must be at least age 59 ½, and second, you must have held the money in the Roth account for at least five tax years (as opposed to dog years). If you meet these two requirements, then your distribution is termed a "**qualified distribution**" and it's totally tax-free.

But what if you have to break into your stash before you are 59 ½, or before you've had the account for at least five tax years? The IRS calls this a "**non-qualified distribution**" and has very specific rules regarding the tax treatment of these distributions.

Amounts withdrawn are first deemed to be distributions of your **principal** contributions. Because these were after-tax contributions, i.e. you did not get a tax deduction for them you are entitled to recover these contributions at any time on a tax and penalty-free basis.

After you've recovered your contributions, what remain must be earnings, and these earnings have never been taxed. On nonqualified distributions, these untaxed earnings will be subject to income tax but not to the premature distribution penalty of 10%, if the following exceptions apply:

1. Medical expenses that exceed 7.5% of your Adjusted Gross Income (AGI),
2. Health care insurance if you've been on unemployment for at least 12 weeks,

3. Substantially equal periodic payments,
4. Qualified higher education expenses (though I would advise that a \$500 per child per year education IRA is a better option),
5. Distributions taken with the first five years for any of the following reasons:
 - a. You reached age 59 ½,
 - b. You died (don't ask me to explain),
 - c. You became disabled,
 - d. You are buying your first home.

Distributions taken from a Roth IRA for any reason other than those listed above are subject to income tax **and** the 10% IRS penalty on the earnings withdrawal. By the way, for those of you in California, there is an additional 2½% premature penalty tax that applies, making the total penalty on premature withdrawals 12½%.

Roth Contribution Requirements: There are two basic requirements: (1) you or your spouse must have earned income and (2) your Modified Adjusted Gross Income (MAGI) cannot exceed certain limits.

Single Filers	<u>MAGI</u>	<u>Contribution Amount</u>
	\$95,000 or less	\$2000
	\$95,001 - \$110,000	Partial contribution
	More than \$110,000	No contribution
Married Filing Joint	<u>MAGI</u>	<u>Contribution Amount</u>
	\$150,000 or less	\$2000
	\$150,001 - \$160,000	Partial contribution
	More than \$160,000	No contribution

Now let's talk about our old buddy the Traditional IRA. Biggest attractions:

1. You can deduct your contributions,
2. Your earnings grow tax deferred.

The money you deposit to your Traditional IRA will reduce your taxable income, provided you meet eligibility requirements. For example, if you have earnings of \$30,000 and you contribute \$2000 to your IRA, your taxable income gets reduced to \$28,000. Easy, right?

The earnings from your tax-deductible contributions then grow **tax deferred** until you reach age 59 ½ and become eligible to take qualified distributions. At that time, any distributions you take will be taxed at your then-present tax rate. This is a good thing for individuals who expect to be in a lower income tax bracket when they retire.

What if you need your Traditional IRA money before you're 59 ½? Can you withdraw funds without being taxed and/or penalized? You can't avoid the tax, but you can avoid the 10% IRS premature distribution penalty under the following conditions:

1. You become disabled,
2. The distributions are for medical expenses that exceed 7 ½% of your AGI,
3. The distributions are part of substantially equal periodic payments,
4. For health care insurance if you've been on unemployment for at least 12 weeks,
5. For qualified higher education expenses (you know my advice on that),
6. For first-time home purchase.

You will be taxed at your ordinary income tax rate on these distributions.

How do you qualify for a Traditional IRA? If you are under the age of 70 ½ and have earned income, you qualify.

How do you get a tax deduction for your contribution? That depends on whether or not you actively participate in an employer-sponsored retirement plan. If you're single, or married for that matter, and neither you nor your spouse is an active participant, you are each eligible for a full \$2000 deduction, no matter how much income you earned during the year.

If either one of you is an active participant, the deduction will depend on you MAGI and filing status.

Single Filers	<u>MAGI</u>	<u>Contribution Amount</u>
	Less than \$32,000	\$2000
	\$32,000 - \$41,999	Partial contribution
	More than \$42,000	No contribution
Married Filing Joint	<u>MAGI</u>	<u>Contribution Amount</u>
	Less than \$52,000	\$2000
	\$52,000 - \$61,999	Partial contribution
	More than \$62,000	No contribution

For those who are covered by a retirement plan at work, and whose income exceeds these limits, a contribution to a traditional IRA would not be tax-deductible.

Which IRA is better? The answer to this question depends on many factors, such as:

1. Your current rate of taxation,
2. Your anticipated future rate of taxation,
3. Your estimated rate of return on investment assets while in the growth phase,
4. The number of years before retirement,
5. Alternative uses of your money-what would you do with the money you've saved because of the tax deduction of the traditional IRA? Would you invest it or would you spend it?

Below is a discussion of these factors.

1. **Retirement tax bracket:** The advantage of the Traditional IRA is that it offers the opportunity to claim a deduction when you are in a high tax bracket, and take a withdrawal as ordinary income when you are in a low tax bracket. The Roth does not provide this benefit because your contributions were never tax deductible.

Also, if you expect to be in the same or higher tax bracket by retirement age, the Roth is more likely the better bet because of its tax-free growth character.

2. **Non-deductible Traditional IRA:** Not all contributions to a traditional IRA are tax deductible. If your contribution does not qualify as tax-deductible, the Roth is definitely the better way to go. Why pay tax on your earnings from a nondeductible IRA when you can withdraw **tax-free** earnings and principal from your Roth when you reach 59 ½?
3. **Nature of your assets/Estimated Rate of Return on Investment Assets** If you'll be investing in assets with a high potential for appreciation, then the Roth makes sense. All that appreciation will be distributed out tax-free to you.
4. **Years to Retirement:** A rough rule of thumb suggests that if you are more than 20 years away from retirement, and can afford to forego the tax deduction from a deductible IRA, then take the Roth IRA approach. The virtue of tax-free savings will more than make up for the current tax hit.

Converting Your Traditional IRA to a Roth IRA

Assets in a traditional IRA can be converted into a Roth IRA. There is a tax cost though-you must pick up as ordinary income the fair market value of your traditional IRA at the date of conversion. No premature distribution penalty applies however. The tax on Roth conversions must be paid in full in the year of conversion.

As always, discuss your financial and tax situation with your tax pro and good luck.

Capital Gain Basics by marc

The proliferation of online brokerages, up-to-the-minute stock quotes from broadcast and cable television programs and business radio and interactive websites has resulted in unprecedented number of Americans taking control of their financial destinies by becoming active investors.

Information that not long ago was available only to your broker and institutional investors is now at your fingertips via websites like ClearStation.com. You can get comprehensive market information, from background reports on publicly traded stocks to economic analyses and vital market statistics. By the way, you can also get all that and some much-needed humor when you listen to the ClearStation *Big Biz Radio Show* at www.ksdo.com, nightly at 5pm PST.

All this trading activity is, hopefully, resulting in lots of profits for investors. That's a good thing. However, it's also resulting in investors having to spend more time worrying about taxes, record keeping, and capital gains issues. That's not such a good thing, unless you're organized and know how to do it. The information in this article will hopefully help you in this task.

The IRS considers the buy and subsequent sale of a stock to be a completed transaction. You've bought a stock and you've sold it, and the difference between your proceeds and your cost basis is reportable as gain or loss on your Form 1040, Schedule D (Capital Gains and Losses).

Huh? Please explain some of those words for me!

The easiest way to clarify some of this new terminology is to take a look at the Schedule D, where you will actually report your stock sales. A copy of Schedule D is included, as part of this article for your reference, and the following examples will be coded to that Schedule D.

Example 1: Sale of Stock

You've bought 100 shares of Microsoft Corporation, symbol MSFT, for \$85 per share on April 12, 1999, and paid a commission on the purchase of \$10. Your cost basis for this transaction is \$85 X 100 or \$8,500 plus the commission for a total cost of \$8,510. You sold this stock on December 21, 1999, for total proceeds after paying commission of \$9,510.

From a tax viewpoint, your proceeds of \$9,510 less your cost basis of \$8,510 have created a capital gain of \$1,000. Because you owned the stock for less than one year, this is considered a short-term capital gain. A holding period of more than one year would have converted this into a long-term capital gain.

By the way, who cares if the gain is long-term or short-term? You should! Short-term capital gains are taxed at ordinary income rates, which can go as high as 39.6%, while long-term capital gain rates are either 10% or 20%, depending on what is your tax rate for ordinary income. If your tax rate is 15%, the lowest tax bracket by the way, then your long term capital gains will be taxed at 10%; if the tax rate on your ordinary income is taxed at 28% or higher, then your long term capital gains will be taxed at a maximum rate of 20%.

This 20% ceiling rate of taxation on long-term capital gains versus the 39.6% rate of tax on ordinary income is the reason that long-term capital gains are considered to have "preferential tax treatment". Remember short-term capital gains are considered to be ordinary income and are taxed at that potentially much higher rate.

Your cost basis in this example is your cost of the stock plus the commission that you paid. It's your net investment in the stock. The difference between your cost basis and your proceeds determines the amount of your capital gain.

Example 2: Stock Splits

Because you're so smart, this time we're going to assume that you bought Microsoft Corporation just before a (hypothetical) stock split in May of 1999. Just as before, you've bought 100 shares of Microsoft on April 12, 1999, and paid \$85 per share plus commission for a total cost of \$8,510. After the stock split, you own 200 shares of Microsoft.

Are you better off now that you own 200 shares of Microsoft, while before you only owned 100 shares? To answer this question, let's think of a pie as an example. Yes, hot delicious strawberry rhubarb pie. Your dad cuts it into four slices. He gives you a slice, and so you have $\frac{1}{4}$ of the pie to eat. If you take your piece of pie and cut it into two portions, do you have more pie?

Hopefully, you realized the answer is NO! Stock splits do not increase the value of your investment. After a stock split, generally the price of the stock falls proportionate to the increase in the number of shares. So in our example, if the stock was selling at \$88 per share just before the split, then after the stock split generally the price of the stock will decrease to $\$88/2$ or approximately \$44/share. Of course $\$88 \times 100$ shares is exactly equal to $\$44 \times 200$, which means that the value of your investment does not change because of the stock split!

Now if you sold 100 of your post-split Microsoft shares for \$46/share, you'd have proceeds totaling \$4,600. What would be your basis, and what would be your gain?

Your total investment in Microsoft was originally \$8,510. After the split, your total cost basis must now be spread over 200 shares. Your cost basis per share is halved, from $\$8510/100$ or \$85.10 per share to $\$8510/200$ or \$42.55 per share. So the cost of the 100 shares is $100 \times \$42.55$ or \$4,255, and your gain is the difference between your total proceeds of \$4,600 and your cost of \$4,255 for a capital gain of \$345.

Example 3: Reinvested Dividends Constitute Basis

Your mother bought 100 shares of Schering Plough back in 1985 for a (hypothetical) cost of \$50/share, and a total cost of \$5,000. Schering Plough has been paying dividends all these years to its shareholders, and your mother has chosen not to receive the dividends as cash, but instead to reinvest those dividends and buy additional shares of Schering Plough stock.

Do you realize that reinvesting dividends is actually the equivalent of receiving cash dividends and then choosing to take that cash and buy additional shares of stock? You are increasing your net investment in your company by buying that additional stock. If you don't keep track of "reinvested dividends" you'll be understating your cost basis when you sell, and consequently, overstating your taxable capital gain!

Companies often offer dividend reinvestment. The positive side of dividend reinvestment is that it allows investors the option of purchasing additional shares of stock without paying commissions. It's a great way for people with limited funds to acquire small amounts of stock over time. On the down side, as so very often happens, nobody keeps track of the dividends reinvested into additional shares of stock, and the consequence is that the capital gain on sale is overstated!

For example, your mother sells in 1999 her 125 shares of Schering. You are her tax accountant, and you see that she purchased the 100 shares back in 1985. You ask her where did the extra 25 shares of Schering Plough come from, and what did she pay for them? Do you think that someone has been tracking fourteen years of reinvested dividends? If not, you are overstating your capital gain and paying too much tax!!!

Record-Keeping

In this day and age, it's almost inexcusable not to keep track of your capital transactions, including date of purchase, date of sale, sales proceeds, cost basis, and net gain or loss. You can keep track with a spreadsheet like Excel, or you can use various Internet Web Sites and input your portfolio's data.

A personal note. I'm a tax accountant, and have seen day traders who've sold hundreds of thousands of dollars of stocks during the year and yet have no idea what their net gain was. There have been situations where the trader has thought he'd lost hundreds of thousands, and yet had made big profits. Without tracking your portfolio, how can you know how you're doing?

We know the IRS demands an accounting for your stock sales, so to trade without adequate record keeping is like the ostrich burying his head in the sand. It won't make the IRS go away not to keep records!

Wash Sales by marc

So you've got this stock that's been a lame duck for a while, but for whatever reason you don't want to get rid of it. You feel like you should get some sort of tax benefit from the "loss" you've incurred, but you know the tax law won't allow that loss until you sell the stock. What do you do?

Some crafty Clearhead would probably come up with a scheme to sell the stock and claim the loss, and immediately buy it back. Pretty clever idea, right? Ah boys and girls, if only things were that simple. In its never-ending efforts to keep crafty taxpayers from outsmarting the system, our friend the IRS has crafted a rule to disallow losses resulting from such trades; this is known as the wash sale rule.

Under Internal Revenue Code 1091, a loss due to the sale or disposition of stock or securities is not deductible if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires substantially identical stock or securities. Say what? In English, please!

Say you bought 1000 shares of ABC stock in 1995 for \$10 per share. January 15, 2000 the stock is trading at \$5 per share and you know it's bottomed out. In addition, you've realized some gains during the year and want to offset these gains with some trade losses. So you sell all 1000 shares and realize a \$5000 loss.

Under normal circumstances you'd be able to offset your trade gains with the \$5000 loss and if any capital loss is left over, that loss can be applied against \$3,000 of ordinary income, with any remaining capital loss being carried to future years. But this scenario has a twist.

As previously stated, you knew the stock had bottomed out, so there was nowhere to go but up. So you bought back 1000 shares of ABC stock the very next day, for \$5 per share.

The IRS will not recognize the loss on this sale. You had 1000 shares and now you still have 1000 shares. You are in the **same place** as far as the IRS is concerned.

Also notice that these new shares are "substantially identical" to your original shares, i.e. it's the same stock in the same company.

So the IRS won't allow the loss, at least not until you sell those "replacement" shares.

The wash sale period for any trade that results in a loss is 61 days; 30 days before the sale, the day of the sale, and 30 days after the sale. So if you want your loss to stick, as far as the IRS is concerned, you need to avoid buying the same stock during the restricted wash sale period.

The wash sale rules apply only to trades that result in a loss. Trade gains resulting from wash sales are taxable in the year of the sale. As the Church Lady would say, "Isn't that convveeee-nient!"

You may be asking yourself, "so does a wash sale disqualify the loss from ever being utilized?" The answer is, maybe and maybe not. Let's consider the consequences of a wash sale:

1. When a wash sale occurs, you are disqualified from taking a current year's tax loss on the sale of stock.
2. Your disallowed loss is added to the basis of the new stock.
3. The holding period of the original stock sold at a loss is added to the holding period of the new stock.

We've already discussed the first point. Let's talk about the other two points.

Basis Adjustment:

As previously stated, the disallowed wash sale loss is added to the cost basis of the new stock. So the new stock has, in effect, a "built-in" loss equal to the previously disallowed wash sale loss. This is how the wash sale loss can be recaptured. Let's take our previous example:

You buy 1,000 shares of ABC stock at \$10/share. You sell the 1,000 shares at \$5/share, resulting in a \$5,000 loss. You then repurchase 1,000 shares, paying \$6/share. This is a wash sale, and the \$5,000 loss is disallowed. This disallowed \$5,000 loss is added to the \$6,000 cost of the newly acquired stock, giving it a "step up" in basis from \$6,000, its purchase price, to \$11,000.

This basis adjustment makes the wash sale a bit more palatable. If you decide to sell the securities later in the year, the wash sale may have no tax consequence to you.

Let's expand on our previous example:

1. 1995 bought 1000 shares of ABC stock at \$10.
2. January 15, 2000 sold 1000 share of ABC stock at \$5.
3. January 16, 2000 bought 1000 shares of ABC stock at \$6, causing a wash sale loss on 1/15/2000 of \$5,000

Now lets say that on January 20, 2000 you sold the 1000 shares of ABC at \$7 per share. The gain would ordinarily be \$1000, (\$7,000 selling price-\$6,000 purchase price) but because of wash sales rules, you have to add the \$5000 disallowed wash sale loss into the basis of the replacement stock. Consequently you have a \$4,000 loss (\$7,000 selling price-\$6000 purchase price-\$5000 disallowed wash sales loss).

Then, on January 25, 2000 you decide to buy back 1000 shares of ABC stock. The sale on January 20, 2000 is considered a wash sale. The lesson here is, wash sales can create subsequent wash sales.

Holding Period:

The holding period of the original securities sold at a loss in a wash sale is added to the holding period of the new securities.

So whether the sale of the replacement securities is long-term or short-term requires that you look back to the date of the original stock buy that was subject to wash sale rule. If that security was bought longer than 1 year ago, then the sale of the replacement securities is a long-term capital gain.

Can I Beat the Wash-Sale Rule?

What can you do to avoid the 30-day wash sale rule?

1. Don't buy replacement stock during the restricted wash sale period. **61 days** - 30 days before the sale, the actual day of sale, and 30 days after the sale.
2. If you're convinced the stock has bottomed out, buy replacement stock 31 days before selling it. If the stock goes up during this period your gains are doubled, and if it's value stays unchanged you can sell the older stock and claim your tax loss deduction. Just hope the value doesn't go further south-ouch!
3. If your stock moves identically to some other stock, you may be able to "have your cake and eat it too" by selling your losing shares and buying "replacement" stock in another company. Stock of one issuing company is not "substantially identical" to stock of another issuing company, even if they're in the same industry.

For further details regarding wash sale rules, read IRS Publication 550 "Investment Income and Expenses", or check out the IRS website at www.irs.ustres.gov. And, as always, consult with your tax expert.

Meeting with your Tax Expert by marc

You've survived the holidays, New Year's eve, and even the Y2K Apocalypse. You're bravely advancing full tilt into the 21st century, anxiously anticipating all the wondrous adventures that await you.

Not so fast, Racer X! Before you conquer the world and make the streets safe for all mankind, you must first overcome a momentous hurdle. By April 15th you must be prepared to report and pay your prior year's income taxes to your ol' Uncle Sam.

On August 5, 1997 President Clinton signed into law the 1997 Taxpayer Relief Act, which introduced new rules that affected virtually every 1998 filer. Individuals who prided themselves on their ability to prepare and file their own tax returns, unexpectedly found themselves searching the Yellow Pages and asking their Uncle Charlie to recommend a good tax professional.

Those who already had a tax professional who prepared their returns found that bringing a shoe box full of unopened envelopes marked "Important Tax Documents" would no longer suffice. It was time for individuals to get down in the proverbial tax trenches with their tax pros, and team up to maximize their tax savings.

By following the steps below, you will help ensure that your pro prepares your returns accurately and gets you the tax savings you deserve. In addition, by being prepared, you'll lower your tax preparation bill because your pro will have everything needed to prepare your returns.

So let's get started with what you need to provide to your tax pro:

1. **Organized, comprehensive documentation.** Most tax pros will send their clients a tax organizer sometime in mid to late January. The organizer is used differently by individuals. Some go through and fill out each applicable page of the rather extensive booklet while others use it to line the bottom of their parakeet's cage.

As a prepared filer, you should carefully review the tax organizer. It will help jar your memory about treatments from previous years and it will also inform you of new tax developments that may apply to you.

It doesn't hurt to review your prior year's return to see what deductions were taken and see if you're still eligible to take them. If you're not sure, write your questions down and ask your pro when you meet.

You should review and organize all the third party tax documents you've received, such as W-2s, 1099s, 1098s, etc. If you find errors, contact the issuing party and request that they correct it right away. In case you're not aware, that information is reported to the government in addition to you. It would really suck if Uncle Sam was under the mistaken impression that you had an extra \$90,000 in earnings because someone included an extra zero on your 1099. Don't laugh, I've seen it happen.

Next, organize and compile your deductible expenses. This does not mean putting all your freakin' receipts in a shoebox and handing them to your pro. Give the guy / gal a break! The best way to do it is to group together your receipts and backups by tax schedule (A, C, E, etc.). Then, on an Excel spreadsheet (or on paper with pencil for those of you who think the US Post Office is the only true way to send a letter to a friend) total up the receipts (by expense category) under the heading for their respective tax schedules. For example:

Schedule A

medical expenses	\$4,000
Mortgage interest	\$15,000
state & local taxes	\$6,000
Charitable donations	\$250
Casualty & theft losses	\$1,000
Miscellaneous expenses	\$1,200

The above schedule is very general, but you get the picture. Incidentally, if you go through the tax organizer carefully, you'll find the requisite "Q&A" boxes where you can input your summarized totals.

For self-employed individuals who file a Schedule C, I recommend using an accounting software package such as Quicken or Quickbooks to track your income and expenses. I will address this issue in more detail on a future column.

2. **Update of 1999 events.** Were you married, divorced, or separated during the year? Was there a birth or death in the family? Did you provide support to an elderly parent? Did you pay any individual for domestic services during the year (i.e. a nanny)? Did your rotten, ungrateful kid drop out of college?

You may or may not be aware but in addition to the various financial transactions that occurred in the previous year, there are personal events that may impact your taxes. With that in mind, you should be prepared to disclose all your life-changing events that occurred in 1999, even if you're unsure whether or not there's a tax consequence.

3. **Ask good questions.** You should have enough knowledge of current tax events to be able to ask effective questions when you meet with your tax pro. I'm not suggesting that you undertake learning the tax code or sign up for the H&R Block tax course. I am proposing, however, that you take some time and familiarize yourself with major recent changes in the tax code to see if any will impact you. In doing this, you will also impress on your tax pro that you're an informed client and he or she needs to pay close attention when preparing your return (read on to learn what you should expect from your tax pro).

Now you may ask, "Where and how am I going to familiarize myself with tax news?" Good question! With the advent of the Internet, anyone with a computer and a modem can now access information that at one time was available only to tax professionals or government representatives, if it was available at all.

There are excellent sites where you can obtain latest tax news and information, forms, even tax advice from professionals, **all for free**. The following are a few of the ones that are out there:

- www.irs.gov - The IRS has a winner with this site! You can get the latest federal tax news, download tax forms, get information for businesses and individuals, order products, and more. Very user-friendly and understandable.
- www.taxsites.com/state.html - This is a pretty cool site that offers links to state tax agencies for all 50 states, state tax law resources, news, federal and state-level tax organizations, and a zillion other directories. **Tons of information!**
- www.taxresources.com - A comprehensive site that offers links to federal and state tax agencies, forms and publications, newsgroups, professional tax articles, software, and a whole lot more! If you want it, it's here!

You can also find a wealth of links by running a browser search for keywords "tax sites".

For those who prefer getting their information from books instead of the Internet, *Taxes for Dummies®*, 2000 Edition, is the latest release in the series of books that offer answers on various personal income tax topics in plain English and with much needed doses of humor.

Whatever method or source you select to use, the bottom line is that it is very much in your interest to get acquainted with current personal income tax rules so you and your tax pro can team up to prepare your winning return.

Now that you know what you need to provide to your tax pro, what should you expect in return (no pun intended)? Here's a list of criteria on which you should not compromise:

1. **Competence.** Your tax pro should be knowledgeable of the tax code and have up to date reference resources. He or she should be aware of changes in the tax laws that may impact you and be able to clearly explain them to you (this is where your familiarity with tax rules pays off). Don't be afraid to ask questions such as what type of continuing education he or she has taken recently and make sure your pro is using current high-end software for tax preparation (i.e. Intuit Pro Series or Lacerte) and tax research (i.e. Kleinrock or PPC).
2. **Reasonable Fees.** Most tax professionals will prepare an engagement letter for you to sign, detailing the work to be performed for you, who will specifically be performing the work, and the cost of the services. If your pro does not provide you with an engagement letter, insist on getting a quote of how much it will cost to prepare your returns. He or she should be experienced enough to give you a fairly accurate estimate. If the final bill far exceeds the original quote, your pro should provide you with a detailed schedule of charges.
3. **Support.** This is a broad, yet crucial, criterion. It encompasses various requirements that must be met in order for there to be a positive and effective relationship between you and your pro:
 - a. Your questions and concerns must be responded to promptly and accurately.
 - b. Your work must be completed within a reasonable time so as to assure that you are able to timely comply with all filing requirements.
 - c. You should be advised of any estimated payments that must be made during the year, and you should be encouraged to participate in year-end tax and financial planning.
 - d. Your pro should work with you to find ways for you to keep more of your earnings and pay less in taxes.
 - e. Your pro should never support or advise you to commit tax fraud.
 - f. Your pro should be available to support you if your return is selected for audit.
 - g. If your pro commits return errors that result in you being penalized, he or she should be willing to pay the penalties and related interest charges.

How do I find such a competent tax preparer? One good method is word of mouth reference by satisfied colleagues. There is nothing as good as a personal recommendation from a satisfied customer to turn you onto someone competent.

By observing the above suggestions, you'll greatly increase your chances of filing an accurate return this April 15th. You'll also increase your chances of keeping more of your income and paying less in taxes. Like my grandmother used to say, "a stitch in time, saves nine." I don't know how this relates to what we're discussing but it sounds kinda cool.

Tax Glossary

Adjusted Gross Income

Adjusted gross income equals gross income less reductions that are allowable irrespective of personal deductions or exemptions.

Alternative Minimum Tax

IRS mechanism created to ensure that high-income individuals pay at least some minimum amount of tax regardless of deductions, credits, or exemptions. It operates by adding certain tax-preference items back into Adjusted Gross Income (AGI). The alternative minimum tax is computed on Form 6251.

Bargain element

The difference between the strike price and the FMV of the stock; also referred to as the "spread".

Basis

Tax term meaning purchase price, including adjustments, used to determine capital gain or loss for tax purposes.

Basis of Stock

If purchased, the amount paid for the stock. If the stock is received as a gift, basis is generally the basis of the previous owner or the fair market value when received. The basis of inherited stock is usually its fair market value on the date of the decedent's death.

Capital Gain Tax

Tax assessed on profits realized from the sale of a capital asset, such as stock. This rate is more attractive than ordinary income tax rates.

Credit

Reductions of tax liability for various purposes to taxpayers who meet the qualifications. Some credits are refundable and the IRS will send the taxpayer a check for any amount that exceeds the tax liability. Most credits are not refundable, but some credits may be carried to other tax years.

Deduction

Amount that may be subtracted from taxable income. See also definitions for "credit" and "exemption".

Education IRA

Savings plan under which the taxpayer may contribute up to \$500 per year per eligible beneficiary. Contributions are nondeductible. Earnings are tax free and withdrawals are also tax free if used to pay for qualified higher education expenses.

Exemption

An amount (\$2,750 for 1999) allowed by law as a reduction of income that would otherwise be taxed. There are two kinds of exemptions: personal and dependency.

Fair Market Value (FMV)

The amount at which property would change hands between a willing buyer and a willing seller, neither being obliged to buy or sell and both having reasonable knowledge of the relevant facts.

Gain

The excess of the amount realized from a sale or exchange over the adjusted basis of the property sold or exchanged.

Holding Period

The length of time a capital asset is owned by an individual. Assets owned 12 months or less are held short term; those owned more than 12 months are held long term.

Incentive Stock Option

Option that has satisfied the qualification requirements under IRC Section 422(b); also referred to as ISO.

Nonstatutory Stock Option

Any option that does not fall within the definition of a qualified stock option; also referred to as NQSO.

Option Price

Tax term meaning the same thing as "strike" price; also referred to as "exercise" price.

Ordinary Income

Income that is fully includable in gross income and that does not have the characteristics of capital gain.

Realized Gain or Loss

The difference between the amount received upon the sale or other disposition of property and the adjusted basis of the property. See also definition for "recognized gain or loss".

Recognized Gain or Loss

Taxable portion of realized gain or loss.

Statutory Stock Option

Stock options that meet Internal Revenue provisions 421 through 424; also referred to as incentive stock options, ISO's and qualified options.

Stock Dividend

Additional shares of stock distributed to shareholders as a percentage of the shares owned.

Stock Option

The right to buy a fixed number of shares of stock for a set price during a specific period of time.

Stock Split

Additional shares of stock distributed to shareholders based on the ratio of shares owned. The basis of the original shares is generally apportioned equally to the total shares owned after the split.

Taxable Income

Adjusted gross income, less personal deductions, less personal and dependent exemptions.

Vested

Having the rights of ownership even if your employment terminates.