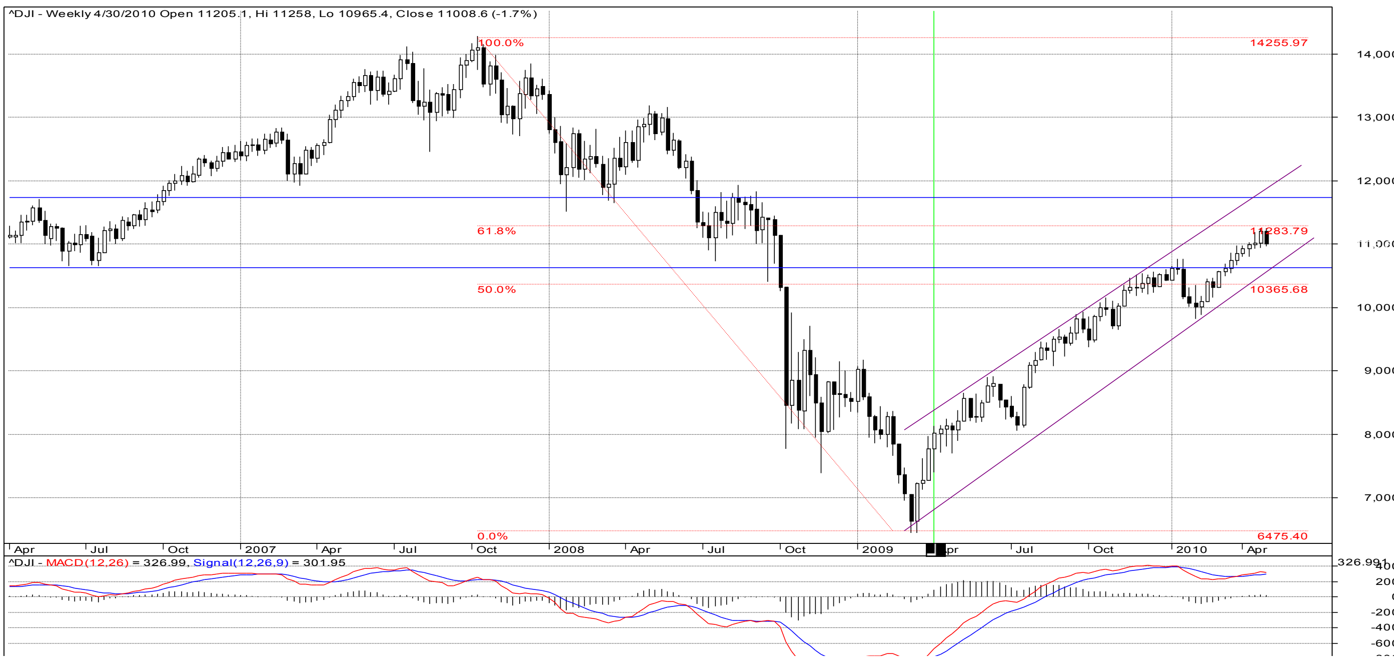
Sunday May 2, 2010
Volume 2, Issue 19

5-Step Investing

By Mark Bates, Certified Financial Technician by the International Federation of Technical Analysts.
Email: MarkJBates@bellsouth.net

Step 1 – Broad Market Trend

Primary Trend:	Upward.	Started March 6, 2009 at 6626.
Intermediate Trend:	Upward.	Started February 12, 2010 at 10012.

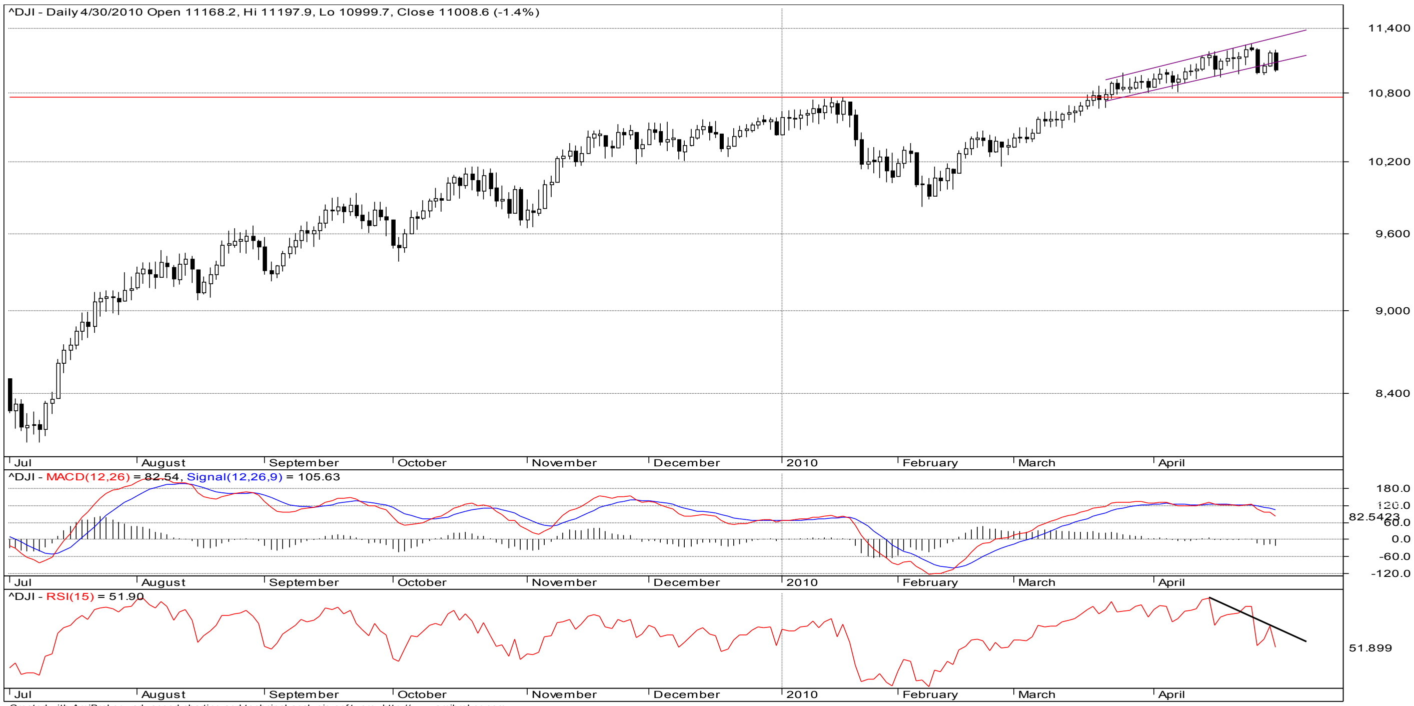


The Dow Jones Industrial Average (^DJI) declined 1.7% last week, finishing at 11,008. As I mentioned last week, the 11261 Fibonacci line is offering resistance. Following that, there is potential resistance at the upper Blue line at 11711, which is now a 6.4% gain away.

I said two weeks ago that “There are plenty of “contrarian” indicators that suggest a correction in the air”. As you can see from the chart above, last week was nearly a complete reversal of the prior week. From a broad market perspective, activity however is still well within the twin purple trend or channel lines, so last week was a warning and not actionable yet.

Step 2 – Near Term Market Trend

Intermediate Trend. Upward. Started February 8, 2010 at 10195.
Short Term Trend. Upward. Started March 1, 2010 at 10337.



Last week I remarked "If on the other hand the market drops 1.7% and closes below the lower the of two new trend lines, it will demonstrate further weakness and suggest the beginning of a correction back to 10000."

There are three reasons to believe that at least a short-term correction is beginning:

1. The upward trend has now violated two trend lines – the sharper one from a few weeks ago, and now the purple trend line above. Clearly the growth in the market prices is weakening.
2. The red MACD line is now clearly below the blue signal line. As I told you several weeks ago, when that resolved itself it would likely be to the downside and would indicate a change in price direction.
3. Note divergence in Relative Strength. RS is a measure of the movement of the price against its itself. In the past, when RS moves down, so does the index. RS has been moving down, but not so the index...yet. I believe that time has come.

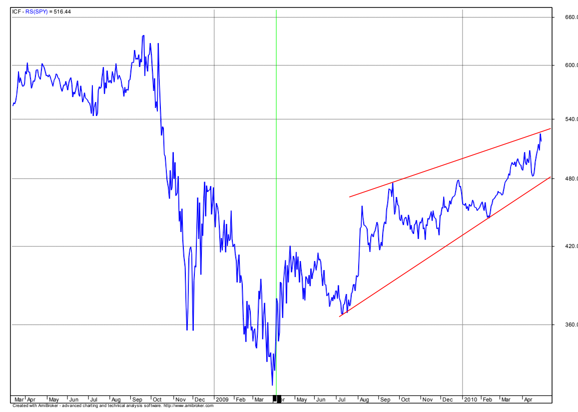
This is the strongest evidence to date of the short-term market correction that has been some time in coming. You can at least expect a correction down to 10758 (the horizontal red line) and if it goes down past that point then we'll reevaluate. As an intermediate term investor, keep your stop losses appropriately tight at this point.

<u>Step 3 – Asset Classes</u>

The charts below are <u>not</u> the price of the security. They are the ratio of the price of certain ETFs to the value of the SPY (S&P 500 ETF).

Bonds (AGG) continue to under-perform relative to the S&P 500, although you can see a recent uptick in bond strength relative to the overall market. Until the upper trend line is pierced, there is no sign of need to shift to this safer asset class.

Real Estate (ICF) continues to outperform relative to the S&P 500. It should be overweight in your portfolio.



Gold (GLD) has broken out above the triangle that was spoken of last week. It is showing strength relative to the overall market. At least in the short term, coupled with the Bond strength above, this confirms a weakening of the overall market and a movement of monies to the safety of GLD.

Dollar (UUP) has moderated in strength against the S&P 500. It is at the apex of a descending triangle, so in technical terms we might soon see it break sharply in one direction or the other.

Step 4 – Current Portfolios

ETF Hedge Fund

The mechanical models that dictate the guidance below appear indifferent to my Near Term cautionary observations about the market, but in fact stop losses are tightening.

Update your stop losses on any existing investments. Every investment should have a stop loss.

						Stop Market	
Security	Weight	Long-Term	Medium Term	Short Term	Price Now	BUY	SELL
SPY (S&P 500 ETF)	Overweight	BUY (Jan 25) (109.77)	BUY (Mar 19) (115.97)	BUY (Feb 11) (108.13)	118.81	122.06	117.06
AGG (Bond ETF)	At weight	BUY (Apr 30) (104.89)	BUY (Apr 30) (104.89)	BUY (Apr 13) (104.19)	104.89	105.10	103.77
ICF (REIT ETF)	Overweight	BUY (Jan 25) (50.15)	BUY (Mar 5) (54.36)	BUY (Feb 16) (50.30)	61.36	64.10	58.17
GLD (Gold ETF)	Underweight	BUY (Feb 1) (108.35)	BUY (Apr 23) (113.19)	BUY (Apr 1) (110.26)	115.36	115.75	110.16
UUP (Dollar ETF)	None yet	HOLD	BUY (Dec 18) (23.01)	HOLD	23.96	24.23	23.60
DOG (S&P Inverse)	None yet	SELL (Jun 30) (66.50)	SELL (Feb 17) (52.47)	SELL (Feb 16) (52.75)	48.80		
MUB (Tax Advantaged Bond)	At weight	BUY (Mar 17) (103.41)	BUY (Mar 17) (103.41)	BUY (Apr 16) (103.48)	104.15	104.39	103.12

Recommended Weights for Portfolios

	Conservative	Aggressive
S&P 500	55%	60%
Bonds/Cash	30%	5%
Real Estate	15%	35%
Gold	0%	0%

Step 5 – New Ideas

Please read updated “Appendix” for new detail on setting BUY and SELL orders.

The Final Word

Jack Schwager wrote a book called “The New Market Wizards”, which is a set of interviews with successful investors and traders. At the conclusion of this book, he cited his own “Observations For Success”:

1. Know what your edge is.
2. Have a method that has an edge.
3. Good trading should be effortless.
4. Never risk more than 1-2% of capital on any single trade.
5. Discipline.
6. Be independent – don't get caught up in hysteria.
7. Confidence --- courage not to panic.
8. Patience – get in at the right time.
9. Think through low risk trading strategies.
10. Catching part of the move is just fine. You don't need to time the bottom or the top.
11. Maximize gains, not the number of wins.
12. Learn to be disloyal to a position.
13. Pull out partial profits.
14. Scared money never wins.
15. Pay attention to intuition.

Legal:

First, among the positions that I hold positions are SPY, AGG, MUB, and IHF.

Appendix: Important Details

Rules for Placing Trades

1) When you place a BUY order, you will also place an associated SELL order for the same security. This is designed to keep you free of constantly checking progress of the trade, and it is designed to build the discipline of always having a set of stops in place to control downside risk. This can be automated on TD Ameritrade by using what are referred to as “Conditional Orders”. On Schwab these are referred to as “Bracket Orders”. Lacking these automated tools, once you execute the BUY order you can go in the day after the BUY and manually place the protective stop.
2) All of your orders (BUY and SELL) will be done using Stop Market orders. That is, on a BUY order the market price must rise to a particular price before you BUY. This gives you initial confirmation that the market price is moving in the expected direction. On a SELL order the market price must fall to a particular price before you SELL.

Rules for Adding New Money to Existing Portfolios or Building from Scratch

1) Only add new monies to securities with BUY in Long-Term, Medium Term and Short Term. Otherwise, keep the money in a money market fund.
2) Do not increase the overall size of the portfolio more than 12% a week, in order to limit market risk.
3) Always enter the noted stop loss amount with each investment. Do not enter a purchase without an associated stop loss amount.

Rules for 401K Portfolios

Segment your 401K portfolio offerings into Equity, Bond, and Money Market. Most equity funds (Large Cap, Small Cap, International, Growth, Value) are very tightly correlated and should be considered as a single asset class. Of these, if you have an S&P Index fund, choose this as your Equity fund. Most bond funds (government, mortgage) are tightly correlated. Of these, if you have a government bond fund, choose this as your Bond fund. You typically will not have a Real Estate or Gold option for 401K portfolios.

1) Apply the Medium Term recommendations above to these two fund options by using the Bonds recommendation for the Bond fund, and the S&P recommendation for the Equity fund. Calculate the percent allocation for the equity fund as the sum of the S&P, Real Estate, and Gold recommendations.
2) Remember that most 401K options have limitations on the frequency with which you can trade the funds or other fund-specific limitations.
3) Avoid using the “target date” funds, as they remain invested in the market at a 65-80% level regardless of market trend.