EDUCATIONAL FEATURE: Anatomy of a Top – Seven Questions for Selling Discipline

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The equity market may be presenting a somewhat ambiguous and / or rotating profile over past months of sharp rallies and retreats, but preservation of capital comes directly from action we take with regard to the *individual stocks* (and / or derivatives) that we hold in our portfolio. There is ample warning to take preservation of capital actions before / if a major market decline might take place, remembering that *the trend is our friend*; that a stock can't go down until it stops going up; and that *most of the time* (with the exception of inverted "V" tops) a period of distribution precedes a decline.

My mentor, Alan Shaw, realizing that a good deal of analytical frustration materializes simply by the lack of logical reasoning, set forth the "Seven Questions" discipline; easy rules that tend to occur more or less in the offered sequence.

First of all, when analyzing a stock or a market index for a ***potential reversal of trend***, a simple but most important question must be asked:

1) ***Does the stock / index have a move of substance to reverse?*** A major reversal formation certainly would not be looked for in a stock that has only moved from 20 to 26, but if a move from 20 to 60 or to 200 or more has been experienced, any reversal in trend could become major.

(Clearly, following gains in excess of 100% plus from the March 2009 lows (even since 2016), many stocks had rising moves of substance in place!)

If the first question is answered "Yes," we then ask:

2) ***Has the stock / index fulfilled readable price objectives?*** Technical analysis does generally afford the opportunity to calculate price objectives based on the size of the accumulation and / or consolidation pattern preceding the advance.

(The indexes and multiple stocks into the 2021 high achieved readable targets from the 2009 (or 2016) basing configurations and exceeded them generously.)

If the answer to question 2 is "Yes," then we move to:

3) ***Has the stock / index violated its uptrend?*** The occurrence of a trend violation could represent the technical forerunner, or an early warning, of a reversal in the major direction of the stock's price movement.

(A growing number of stocks have breached their initial uptrends.)

If "Yes," question 4 then asks:

4) ***Are there signs of distribution evident?*** Evidence of distribution can take on many forms. Charts display certain patterns (a double top, "head-and-shoulders," a descending triangle, or even a horizontal pattern, as examples) and pivot off the technical assumption that a "period of distribution" precedes declines; but there can *also occasionally be sudden reversals from a new high*.

(A number of stocks portrayed / are portraying patterns of distribution; and as some rallies approach 2021 price peaks, one may need to revisit Q 1 and Q 2 in evaluating the potential for double tops.*)*

If "Yes," then:

5*) **If distribution is evident, is it significant enough to imply that more than a minor movement in price could be in the offing?*** The greater the distribution pattern, the greater the anticipated decline.
If one has answered the first five questions in an affirmative manner "Yes," then positions should be lightened (or protected) as the affirmative answers accumulate. Question 6 asks:

6) ***Has the stock violated a readable support level?*** A "Yes" answer here would represent a *stop-loss discipline point*, further protecting capital, and takes us to the last question, which one should ***not*** reach with a fully invested position:

7) ***Has the stock initiated a downward trend?*** A "Yes" answer to this should be arrived at with positions closed (or fully protected), or use rallies to complete such action.

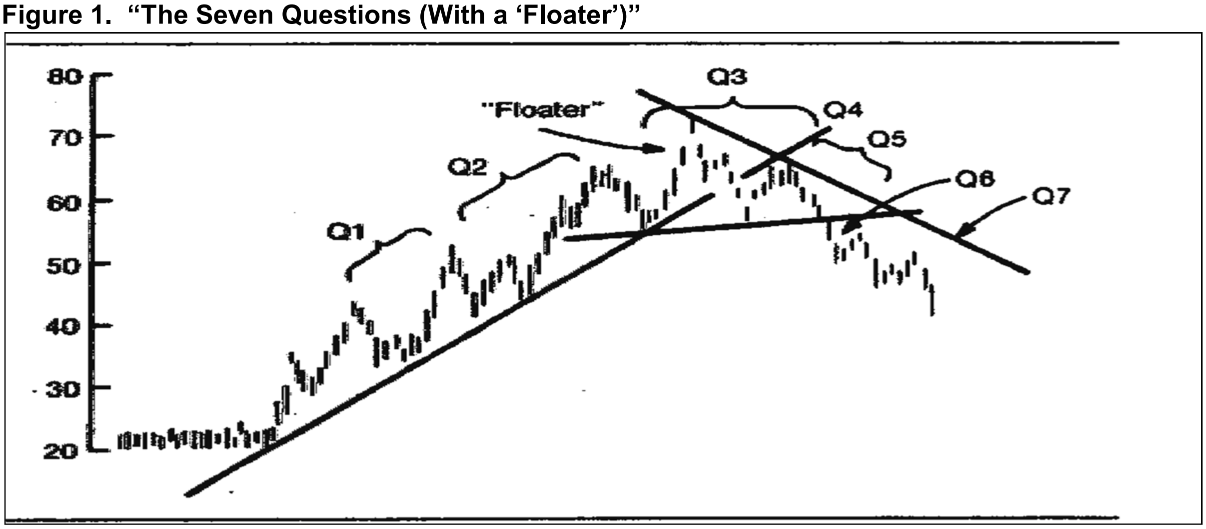
There is a *floater question* which can be inserted in between any of the above seven: *"Is there any evidence of unusual price and / or volume action?"* Sharp upward or downward runs following a major move can often be an indication of a "climactic" phase of market action.

Note: We realize that these evaluations are made more difficult and frustrating in today's proliferation of ETFs, of hedge fund influence, electronic trading, shorting pressures without the uptick rule and intra-day algorithmic programs. But the 7 Qs apply equally to ETFs.

One aspect of the above comes in the form of **"false breakouts" (or false breakdowns)**, in which a breakout occurs *without upward (or downward) follow-through*. There is often evidence of these events in the progress of stocks trends. Therefore, monitoring support levels as prices may fail in their *apparent* breakouts becomes an important preservation of capital discipline.

For an exercise in these questions, please reference the chart below as *an educational example.*

Figure 1. "The Seven Questions (With a 'Floater')"



Source: Courtesy Alan Shaw and LY Advisors

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