Using Trends to Help Avoid Market Pitfalls

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By Debbie Carlson | Contributor

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The current stock market turbulence has investors worried, especially with the Standard & Poor's 500 index and the Dow Jones industrial average down more than 5 percent for the year.

But there are some ways investors can incorporate trend following as a way to manage their risk or to decide whether to invest.

Trend-following is part of technical analysis that uses price patterns and other data to forecast the direction of stocks. It's a popular strategy among some analysts and Wall Street observers, and is something everyday investors can incorporate in their own research. Some exchange-traded fund managers use trend-following as part of their decisions to get in and out of the market, and some have been able to avoid the worst of the current market decline.

The trend is your friend. Steve Wruble, chief investment officer of RiskX Investments in New York, says technical analysis goes back as far as there was a centralized place to see the price of a good on an exchange. "The idea is that there are trends in the marketplace in general, but also with specific areas of the market and specific stocks," he says.

John Person, president of NationalFutures.com in North Palm Beach, Florida, says trend following is often seen as a way to follow stocks and sectors that are moving higher – what is known as positive momentum. "The theory is that positive performance attracts money. Money attracts money, but that's only true up to a certain point," he says.

It's easy to dismiss trend following as chasing performance, but Wruble and Person say that's not the case. "Chasing performance is blindly buying the stock that everyone is piling into," Wruble says.

To avoid chasing performance, Person says investors need to look at trends in the bigger picture. Don't just look at the 52-week performance, but also where prices were three or five years ago to put movements in perspective.

"Looking at it from a longer-term window will give you a better gauge of something may have overshot the runway to the downside and over-accelerated to the upside," Person says.

For example, investors with a short view might think that the Health Care Select Sector SPDR exchange-traded fund (ticker: XLV) is undervalued because it's lost more than 10 percent of its value since July. But examining the ETF through a longer-term window reveals that even with the dip, the XLV is relatively expensive, having gained more than 108 percent in the last five years. By contrast, the Energy Select SPDR ETF (XLE) is down about 16 percent in the last five years.

"Value investors looking to buy cheap may be focusing their attention on energy stocks," Person says.

Conversely, the drop in health care stocks does not necessarily represent a bargain for value investors and the downward trend may give an investor with these assets a reason to adjust their portfolio. "It works for value investors and those also protect your portfolio and get defensive," Person says.

Trend following also works for the broader market. The only stock market sector higher on the year so far is utilities. If the overall stock market was heading in an upward trend, Person says he'd expect to see more sectors starting to turn positive. "Looking at the relative perspective for how many sectors are positive on the year, it does not inspire confidence when only one is up on the year," he says.

Investors can use trend lines on charts to plot if a stock or a market is breaking a trend. For a market that looks like it may fall further, draw a line alongside the angle of the lows and extend it along the chart, connecting at the recent lows. If prices fall under that line, it could be a sign that stock may be taking a larger downturn, Person says. To see if a stock price may be making a sustained higher move, use the trend line measurement to connect the highs at an angle, and watch if prices move higher.

Using trend following for risk management. Sean O'Hara, director of Pacer Financial and Pacer ETFs, uses a trend-following strategy in ETFs as part of risk management. He says following rules helps to take the human emotion out of investing and helps to avoid panicking.

Pacer Financial uses a 200-day moving average, which is the average closing price of a security over the last 200 days. Its ETFs are tied to indices, and depending on the price pattern of the 200-day moving average the specific index's price, the company created a rule that will determine if it invests fully, partially or not at all in the market.

"The purpose of this is not to avoid the 5 to 10 percent movement of prices, but get out of the way of the catastrophe declines that are part of investing," he says.

Blair Hull, founder of Chicago-based Hull Tactical Asset Allocation, uses several technical analysis models to time when to get into and out of markets, He says technical analysis helps with investing discipline.

"The key … is having a consistent discipline and systematic approach. You're not going to be successful without that. Humans have greed and fear. They are opposites, but they influence our decisions. … There are very few people who can stay emotionless," he says.

Wruble says investors shouldn't rely solely on trend following in their decisions, but use it as part of their decision-making process. "There are no guarantees that these trends are going to happen," he says. "Technical analysis is one methodology you can use as you make decisions."

Debbie Carlson Contributor

Debbie Carlson has more than 20 years experience as a journalist and has had bylines in Barron's, The Wall Street Journal, the Chicago Tribune, The Guardian, and other publications. Follow her on Twitter at @debbiecarlson1.