WILLIAM O'NEIL INDIA

MARKETSMITH® INDIA

Using Stock Charts To Win Big

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" What seems too high in price and risky to the majority usually goes higher, and what seems low and cheap usually goes lower. " – William J. O'Neil

The 'N' in the CAN SLIM strategy stands for either a 'New Product,' 'New Management,' 'New High,' or any other new factor, which could positively change the operating environment for the stock and ultimately drives its price into newer realms. Contrary to conventional wisdom, buying low and selling high is not an easy way to make money in the stock market. In fact, it can be quite risky because in many cases, you're buying damaged goods.

We would like to specially draw your attention to buying into new highs. Buying a stock when it is scaling new highs might seem strange and scary to many investors. About 98% of individual investors would never buy a stock that makes new highs. Buying a quality stock at a new high is buying into the emerging strength with a belief that it could prove to be the beginning of the next big move.

But, don't buy every stock that makes a new high, make sure that the stock breaks out of a sound base pattern before it sails above the pivot, on a higher than the average volume. In addition, investing when the stock price is way too extended, say 5–7% or higher from its pivot is not ideal.

Among the eight principal base patterns, including the ascending base, base on base, double bottom, flat base, high tight flag, IPO base, and saucer; cup-with-handle remains one of the most successful to date. Why? Simple. Over the centuries, human nature hasn't changed. Greed, fear, hope, despair, and other emotions drive stock prices. So do the laws of supply and demand. This is why sifting through the charts of the market's greatest winners is time well worth spent.

Cup-With-Handle

The stock needs to show a 30% uptrend from any price point, but it must be before the base's construction. Or, the stock must show a minimum 20% increase from a prior breakout. The cup-with-handle must be at least seven weeks long. If there is no handle, then the cup itself must stretch a minimum of six weeks.

The handle alone needs at least five days to form, but it could go on for weeks. Make sure it doesn't exceed the cup portion in time or the size of the decline. A good cup-with-handle should truly look like the silhouette of a nicely formed teacup. The handle always shows a smaller decline from high to low; it represents a final shakeout of uncommitted holders, sending those shares into sturdier hands in the market. In most cases, the decline from high to low should not exceed 10% to 15%. During bear markets, some good cup-with-handle bases show a large, double-digit decline within the handle. But again, it should not exceed the drop within the cup.

The Handle? It Must Be High Enough

The handle should form in the upper part of the entire pattern. If it's too low, it's flawed. One way to check if that handle is proper: use the simple midpoint test. Add the highest price and lowest price within the handle and divide by 2. That number should be greater than the midpoint of the actual base itself.

Avoid Deep Bases

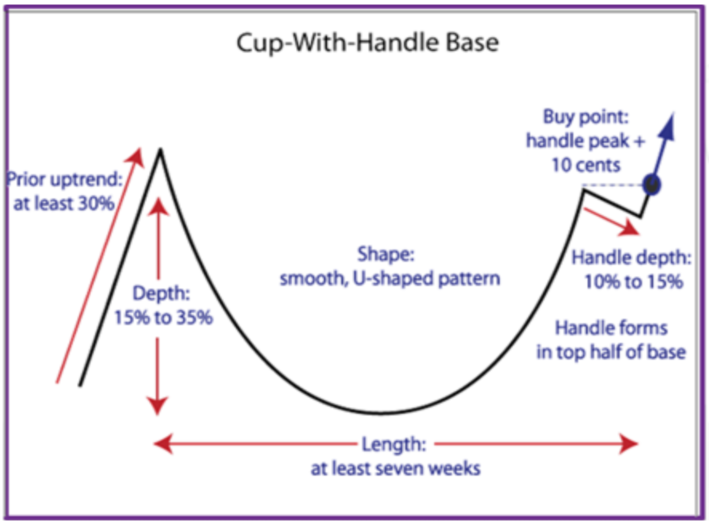
Try to limit your picks to cups that are no more than 30% or 33% deep, except for those built during a bear market. In that case, an exceptional growth stock can fall 40%, 50%, or more and still make a

The Buy Point

This, of course, is where all the above parameters lead if they appear correctly. The buy point from a cup-with-handle base appears at the highest point of the handle.

Volume On The Breakout

When the stock is breaking out, you should generally see a rush in turnover. Volume should ideally rise at least 40% above its 50-day average. For small and midcap stocks, expect breakout volume to double or triple.



Double-Bottom Base

Double bottoms tend to form while the overall market is volatile, and that's reflected in the shape. You have one down leg, then the stock tries to rally but hits resistance and ends up pulling back to form a second down leg. The stock rebounds one more time and is finally able to punch through and move higher. The breakout typically occurs when the overall market has also bounced back from a correction into a new uptrend.

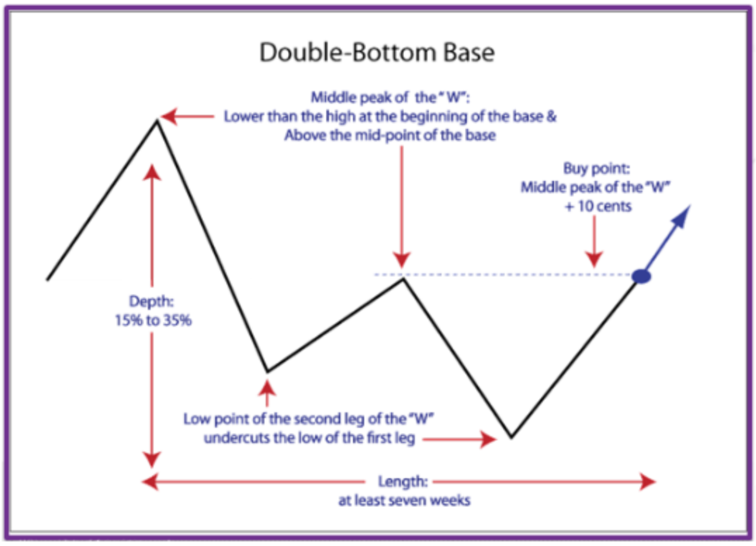
Like the cup-with-handle and all other bases, the buy point for a double bottom is 0–5% above the most recent area of resistance. That's the peak in the middle of the W. Breaking through that resistance on unusually heavy volume shows institutional investors are back in the game, aggressively scooping up shares.

Remember how the handle in the cup-with-handle shook out the weaker holders? You have the same concept here, just in a different place. Note how the bottom of the second leg in a double bottom undercuts the bottom of the first leg. That gets rid of the weaker holders, leaving more committed investors who create support for the stock's new run.

What to look for in a double-bottom base:

- **Prior uptrend**: 30% or more
- **Base depth**: 35% or less
- **Base length**: At least 7 weeks. The first down week in the base counts as Week 1
- **Peak in middle of W**: Should form in the upper half of base and should be below the left-side peak
- **Undercut:** Bottom of the second leg down should be lower than the bottom of the first leg down

- **Volume on the day of breakout**: At least 40–50% above average



Flat Base

Stocks cannot continue to make higher highs despite their superior fundamental and growth stories. They'll go up for a while, take a breather, pull back to form a new base, and then resume their climb – giving you multiple opportunities to make money. The flat bases are a classic example in this regard, which are typically formed after a stock has made a nice gain from a cup-with-handle or double-bottom breakout. That's why they're often considered "second-stage" bases.

Here are the key concepts to understand about flat bases:

- **Trading Sideways to "Digest" Earlier Gains**: Stocks often break out of a cup-with-handle or double-bottom pattern to run up at least 20% before essentially trading sideways to form a flat base. It's a mild decline compared with other patterns (no more than 15%). Usually, the price range remains fairly tight throughout a flat base. It may imply that institutional investors — who have to buy tens of thousands or more shares to establish a large position — are quietly buying within a certain price range. That's how they increase their holdings without significantly driving up their average cost per share.

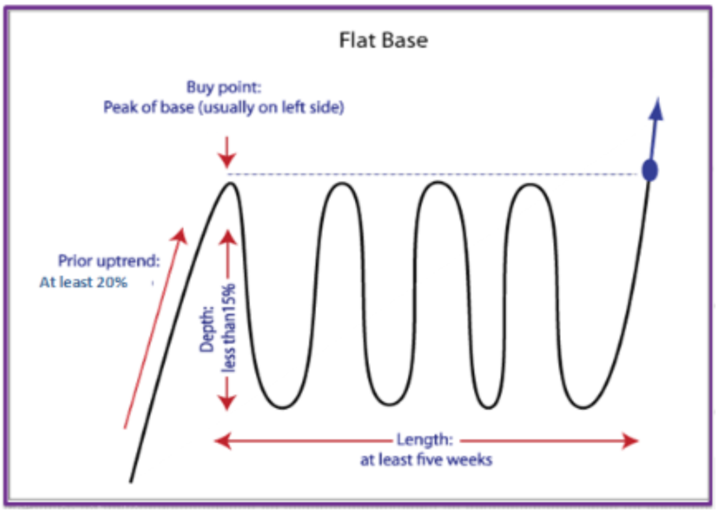
- **Support and Resistance**: Again, the buy point is above the most recent area of resistance (the highest price point within the flat base). Until the stock breaks through that "ceiling" (preferably on above-average volume), it won't be able to launch the next leg of its climb.

- **Shakeout**: Like other patterns, flat bases also have a way of shedding weaker holders
  Instead of a sharper sell-off like the handle in a cup-with-handle or the second-leg undercut in a double-bottom, the flat base shakeout is more of a slow grind. The weaker, less committed investors just get worn out by the indecisive, sideways action, and eventually, lose patience and sell.

What to Look For In a Flat Base:

- **Prior uptrend**: 20% or more
- **Base depth**: 15% or less
- **Base length**: At least 5 weeks.
- **Ideal buy point**: 0 to 5% above the most recent area of resistance (the highest price point within the flat base.)

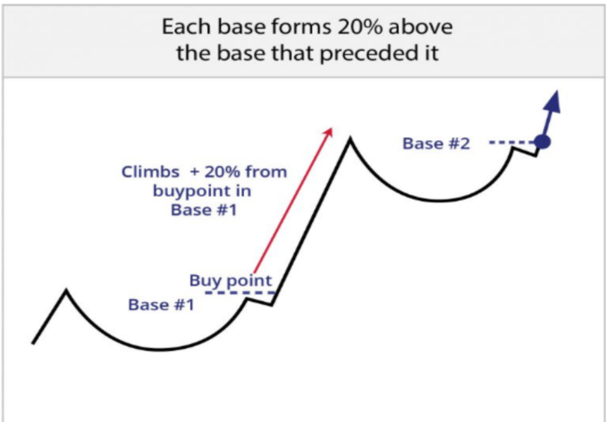
• **Volume on the day of a breakout**: At least 40–50% above average



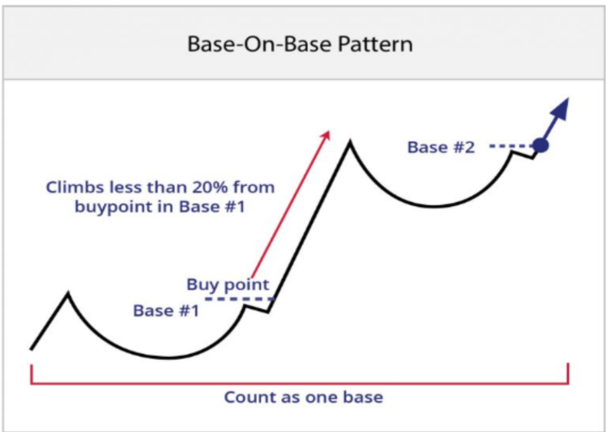
How to Count Bases & Why You Should?

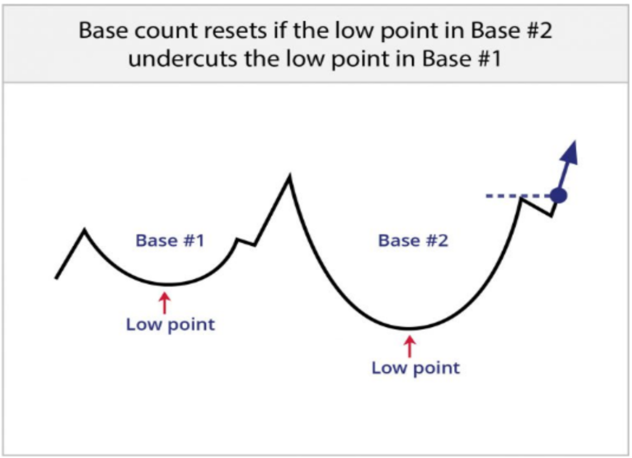
Along with the type of base, it is important to understand the stages of base.

Stages begin at one and increase with each subsequent base pattern formed. The magnitude of the move between two base patterns will determine whether the stage moves numerically or alphabetically. If the price move from the pivot point of the prior base to the left side high of the current base is 20% or more, the stage will increase by a factor of 1—for example, from Stage 1 to Stage 2.



If the price move is less than 20%, the stage will increase by an alphabetic factor—Stage 1a to Stage 1b.





Base stages help investors identify the progress a stock has made in its price advance, the biggest clue to a stock's remaining growth potential. It is a good idea to track the number of bases a stock has formed during its current run-up. As a rule of thumb, try to buy stocks that are breaking out of the first or second base of their run. Late-stage bases are riskier. Late-stage means a base that is number three or higher in the base count.

After forming a fourth base, most growth stocks can't rally much further, if at all. What usually follows is a long, steep slide. After a stock has had a large advance without a major correction, the probabilities are greater that institutional investors will cash in their profits and push the price into a serious decline.

By the time a stock forms a late-stage base, it is usually widely known to investors and running short on fresh buyers. In addition, the late-stage base tends to have unsteady price swings, bouts of strong selling, or other flaws. It is the chart's way of telling you that the best buying opportunities are gone.

Late-stage patterns can work and sometimes do lead to nice gains, but you should understand that they involve more risk. If you buy a stock on a late-stage breakout, be sure to cut your losses quickly if the stock fails to gain traction and begins to head south.

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