# Volatile Markets: Insight on Trading Reversals

By Michael Sincere

Enter too early or too late and you may lose money. That's what trading reversals is all about—determining the correct entry point. With this strategy, you use specific technical indicators to recognize which stocks or markets are overbought or oversold, so you can trade in the opposite direction of everyone else. We talked to trading experts to gain some insight on when and why you may want to utilize this strategy.

**When to get in**

When you trade reversals, "you are basically saying you are smarter than the market," says Dr. Alexander Elder, a professional trader and author of the best-selling book *Come Into My Trading Room* (Wiley, 2002). "After all, the price you see on your screen is what the market thinks is a fair price. The challenge of trading reversals is that every day the market gives you a reason to think the trend is over," Elder says. "It's not easy to keep holding when you're afraid you'll lose your profits."

Howard Korstein, an independent trader with over 25 years of experience, agrees. "People come in too early because they're afraid they'll come in too late. They'll stick out the pain of having further losses rather than wait for the trend to begin," he says. Kornstein would rather be late than early, waiting until a stock stabilizes so he can buy at a slightly higher price. "I am looking for a sell-off that has stopped."

Elder pays attention when a stock reaches its old high or old low. He is a buyer when a stock breaks down slightly below its old low and his indicators show a bullish reversal. "When everyone is afraid the stock is going to go down, I am interested in buying," he says.

Kornstein agrees. "It's often difficult to define if it's truly a reversal that has turned into an established trend," he says.

Alan Farley, author of *The Master Swing Trader* (McGraw-Hill, 2000) and founder of www.hardrightedge.com, likes to buy in mild times and sell in wild times. "I will watch the price action for three or four days," he says. "My ideal entry point is when it's quiet, the volume has dropped, and the market is not moving." On the other hand, when the stock shoots up higher in a rapidly rising market, he'll sell his position. "Buy when they're crying, and sell when they're yelling," he quips.

**What they buy**

Farley says he never tries to pick tops or bottoms. "Amateurs try this, and they get crushed." If a stock looks too high or looks too low, Farley says, it is not a reason to buy or sell. He would rather wait until the market bottoms out or turns around. "A turnaround won't occur if a stock is moving straight up," he says. "If the stock is going to extend, even your indicators won't tell you when it's going to stop. I will wait until the stock has established a range, has a transitional pattern, and all those people who own the stock are afraid to lose their profits." He likes to give the owners a chance to be disillusioned, which is where the eventual sell-off comes from.

He uses the reversal strategy on volatile stocks such as Express Scripts (Nasdaq: ESRX) and Smith and Wesson

(Nasdaq: SWHC). “On the other hand, it’s hard to use this strategy on a story stock like Apple (Nasdaq: AAPL) because there is so much news about it. I like less popular stocks that aren’t in the public’s eye.”

Conversely, Elder especially likes using the reversal strategy on blue-chip stocks. These stocks have well-established charts that are easier to identify for potential reversals. “You probably won’t get hit as hard with the large-cap companies,” he suggests.

According to Kornstein, a recent example of buying a reversal occurred with Countrywide Financial. Because of subprime problems, other financial leaders like Citigroup (NYSE:C) and Bank of America (NYSE:BAC) sold off in unison with Countrywide, although they weren’t involved in the same kind of lending business. “Countrywide got hit because of the subprime problems, and all financial stocks plummeted. This created an opportunity to buy financial stocks at a lower price,” he says.

Farley depends heavily on patterns to determine the best entry price using moving averages and stochastics to get a feel of who is in charge, bulls or bears. In general he looks at patterns, primarily those on the daily chart. “In reversals, you look at topping patterns or bottoming patterns depending on whether you are reversing from an uptrend or downtrend.” For example, a topping pattern is a double or triple top or a head-and-shoulders pattern. The basing pattern is softer, similar to a bowl-shaped pattern. “I might want to short a topping pattern or buy a basing pattern,” he adds.

**Cautions**

Even though you can short on the way up, many pros generally agree that shorting rallies is risky. “Trying to short an overbought stock is dangerous,” Kornstein says, “because the market might not consider it overbought.” For example, Whole Foods Market (NYSE:WFMI) is fundamentally overvalued with a P/E ratio near 35 (compared with a P/E of 15 for other supermarkets); nevertheless, the stock is in the portfolio of many institutions and has a large following. Therefore, Kornstein is comfortable buying this stock on a dip.

Likewise, Farley won’t short a rapidly rising market. “I’m not interested in selling short a strong uptrend.” He prefers to let the stock drop to a support level and go long at a better price. “If you are reading your technical indicators correctly,” he says, “you will find the spot the stock will pull back to, where it won’t go much farther—and that’s where you want to be a buyer.” Farley observes that a stock usually doesn’t reverse without first having some kind of a basing or sideways pattern.

According to Farley, the biggest mistake that people make using this strategy: “they believe a stock will go up forever, so they don’t protect their profits. If you have a profit, don’t assume that the direction will persist forever. You have to manage that position. You have to put a stop under it and be willing to take less profit. The market can unexpectedly turn around, catching you off guard.” This is one reason Farley enters tight stops on rapidly rising stocks that are in the profit zone.

Kornstein also suggests researching the stock you are trading. “To be successful, you have to understand the entire sector the company belongs to and take advantage of an opportunity.” It is not uncommon for Kornstein to watch a stock for weeks or months before taking a position. Many people do the opposite, Kornstein says, impulsively buying a stock based on the morning news. “I prefer buying stocks based on performance rather than on news.”

For those just starting out, Farley suggests trading fewer shares if you aren’t experienced using this strategy. In addition, study a basket of stocks in a specific sector until you become an expert on how these stocks trade, he says. Then use technical indicators and stock patterns to enter or exit your position.

*Michael Sincere is the author of five books about investing and trading, including* Understanding Stocks (McGraw-Hill, 2003) and Understanding Options (McGraw-Hill, 2006).