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Measuring Relative Strength/Weakness

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One of the simplest Wyckoff concepts is one of the most important. It is the concept of relative strength or weakness. Stocks that have established themselves as being relatively strong vs. a general market index or a fixed universe potential trade candidates like the components of the Wyckoff Wave or the Dow Jones Industrials are more likely to be the best candidates for long positions. Issues that are relatively weak to an index or group of other individual stocks are more likely to be the best candidates for short positions. Relative strength or weakness can be measured in two ways. A trader can measure it by simple observation or by doing some simple math.

The Wyckoff trader who is using the observational approach is comparing the tops of rallies and the bottoms of reactions in individual issues to the similar rally tops and reaction lows in a general market index. Identifying the halfway points of rallies and reactions on the individual issues under consideration and a general market index can also be helpful. If the trader is bullish, he is looking for those individual issues that are demonstrating the most consistent pattern of higher tops on rallies and higher bottoms on reactions relative to the similar rallies and reaction in the market index. These observations are going to be most helpful in identifying potential long candidates while the general market is still in a trading range, but early leaders have already begun to trend. If the trader is bearish, he is looking for those individual issues that are demonstrating the most consistent pattern of lower bottoms on reaction and lower tops on rallies relative to similar bottoms and tops in the market index. These observations are going to be most helpful in identifying early leaders to the down side and potential short candidates while the general market is still in a trading range.

The same types of observations mentioned above can also be helpful in identifying trade candidates late in a sustained advance or decline when the general market has moved into a trading range, but some issues continue to trend again demonstrating patterns of higher tops and bottoms to be identified as long candidates, or lower bottoms and tops to be identified as being short candidates.

When both the general market and individual issues are trending in the same direction, identifying the relatively strong and relatively weak issues by observation can be more difficult since both the market and the stocks are doing the same thing. This is where identifying the halfway points of previous rallies and reactions can be helpful. If both the market and individual issues are trending higher, the Wyckoff trader wants to identify those issues that are under performing to the down side on reactions relative to the general market. These will be most obviously revealed in cases where the general market reacts to or through its halfway point of the previous advance and the individual issues hold above their halfway points. These are the issues that are more likely to participate well in the next rally. The same approach works in reverse

when both the market and individual issues are trending lower. Here, the trader wants to identify those issues that are under performing to the up side on rallies relative to the general market and the halfway points of the previous reactions can serve as a good guide in making the observations.

Traders using the observational approach to measuring relative strength or weakness should focus on the obvious and avoid the marginal. Trying to make a case for an issue as a trade candidate where the issue is not clearly making the case for its self usually will lead to disappointing results if a position is taken.

Wyckoff traders who are looking for a more precise way to measure relative strength or weakness or who are looking for a way to confirm the results of the observational approach might want to consider developing a weekly relative strength/weakness report. To do this, the trader will need to determine the percentage change in price at the end of the current week from three previous points in time. Since most Wyckoff traders engage in market operations that are short term to intermediate term in nature, determining the net change over the past week, the past four weeks and the past thirteen weeks is suggested. Traders who are more comfortable with a longer term market operation might want to use the changes over the past four weeks, thirteen weeks and fifty-two weeks. Percentage changes should be determined for both the universe of individual issues being considered and for the general market index that is used.

This approach to measuring relative strength or weakness is best suited for the trader who operates in a fixed and limited universe of individual issues such as the twelve components of the Wyckoff Wave or the thirty Dow Jones Industrials. If the components of the Wave are being used, the trader wants to rate them based on the percentage changes that were determined in the first step of this approach. To do this, the trader assigns a score to each component and to the Wave for each of the three time frames. A score of zero is assigned to the issue that turned in the most bearish performance. A score of twelve is assigned to the issue that turned in the most bullish performance. When this has been done for each of the issues and the index in each of the three time frames, the three scores are added to determine the total for each. The totals will range somewhere between zero and thirty-six if the Wave and its components were used. If the DJIA and its components were used, the totals will range somewhere between zero and ninety-three.

Here are two recent examples of how a weekly relative strength/weakness report could have helped identify two trading opportunities. When the report for the week ending February 20 was prepared, it revealed that one component of the Wyckoff Wave had been among the three weakest during each of the thirteen previous weeks. The issue was BAC. During the most recent week, BAC rallied into a clearly over bought condition as measured by its Technometer indicating that it was vulnerable to a reaction. Wyckoff tells us to sell relative weakness on rallies. In this case, the sustained pattern of relative weakness allowed the price of the stock to decline two points in less than two days, which was a huge percentage move for an issue trading under six dollars per share.

Another example of how the relative strength/weakness report can be helpful in identifying trading opportunities can be found in IBM. When the report for the week ending February 20 was prepared, it revealed that IBM had been among the three strongest components of the Wave

for eight of the previous thirteen weeks. It had reacted to the vicinity of the halfway point of its previous advance putting it in a primary buying opportunity. It was also in a clearly over sold condition as measured by its Technometer. Wyckoff tells up to buy relative strength on reactions. The weekly report indicated that the stock was one of the strongest in the Wave. By the end of last week, the price had taken advantage of its relative strength and had rallied nearly ten points.

The two examples above should not be taken as an endorsement of the idea of being long and short in the same market at the same time. Theoretically, this is possible to do especially if the positions on opposite sides of the market are aimed at different time frames. However, most Wyckoff traders who try this approach tend to not do well at it. Therefore, traders are encouraged to only trade that side of the market that is most in harmony with its trend. That being the case, BAC would have been the better choice for a trade even though IBM rewarded those who choose to take a position in it.