The Art and Science of Profiting from Momentum

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The Art and Science of Profiting from Momentum

By Scott Chan (see bio at end)
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Last week we took a look at moving average convergence divergence (MACD), one of the main indicators used by technical traders. MACD helps traders spot momentum changes and maximize their gains in a short period of time.

MACD is just one indicator in technical analysis. Experienced traders often use multiple indicators to guide their decisions. Today, we examine the relative strength index (RSI) and how you can leverage it to make money. The process requires a marriage of instinct and math.

Looking for Momentum Reversals

RSI is a popular momentum indicator that allows investors to pinpoint stocks that are overbought or oversold. A stock that is overbought is one where buying fervor has lifted the price to a level not justified by underlying fundamentals. On the other hand, an oversold stock is one where selling fervor has dragged the price to a level not justified by underlying fundamentals.

The more overbought a stock, the more likely it is that people who want to buy the stock have already bought it. This means that soon sellers could outnumber buyers. If this does happen, the stock price will fall. The opposite is true for an oversold stock.

Consequently, by trading an overbought or oversold stock, a trader seeks to profit as the stock moves back toward its "fair" value. The idea is that a stock price is like a rubber band. If it goes too far one way, it will snap back.

What the RSI Numbers Mean

The RSI is calculated by comparing the average gain to the average loss over the previous X number of trading days. The default number of trading days is 14, but in practice you can adjust the number higher or lower depending on your preference. When you lower the number, you increase the RSI's sensitivity—you will get more overbought and oversold signals. The opposite is true when you increase the number.

The actual formula for RSI is rather complicated; it would be a burden to calculate manually. Fortunately, modern charting tools will automatically calculate and display the RSI value for you.

The RSI calculation will always return a value between 0 and 100. Traditionally, when the RSI is 70 or higher, a stock is considered overbought. When the RSI is 30 or lower, a stock is considered oversold. In practice, traders sometimes adjust the criteria. For example, they may use 80 and 20 as thresholds instead of 70 and 30, to trade based on a stronger signal.

Divergence: A "Green Light"

Traders also watch for RSI divergence from the underlying stock price as a possible catalyst for action. A divergence means that the RSI and the underlying stock price action are moving in opposite directions. It can serve as a powerful "go" signal.

For example, if a stock makes a new high, but its RSI actually falls, that is known as a bearish divergence. Traders interpret that as a sell signal because it suggests that bullish momentum is weakening. A bearish divergence can be a very powerful signal to sell, especially if a stock's RSI is already above 70.

Sometimes, though, the RSI can give a false signal. For example, if a stock drops 20% due to terrible forward guidance, the RSI may indicate that it is oversold, but the stock's fundamentals have changed. In this case, you would want to ignore the RSI signal and wait until the dust settles before you make a decision.

At the end of the day, the RSI can be an extremely useful tool for technical analysis. But charts alone cannot tell you the whole story. Experience, instincts, and an understanding of the driving forces behind the market and a stock can make the difference between reaping consistent profits and losing your shirt. As many traders will tell you, trading is both an art and a science.

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See About the Analyst below.

ABOUT THE ANALYST

Scott Chan

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Scott Chan moved from China to the U.S.A. with his family at the age of ten. He passed the rigorous entrance exam and attended the merit-based Stuyvesant High School, widely held to be the best public school in New York City. He earned undergraduate degrees from New York University followed by an MBA degree from the Zicklin School of Business at Baruch College.