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## Call the downturn with a 40-week moving average

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A recent article in The Globe and Mail quoted William O'Neill, author of *How to Make Money in Stocks*, who suggested to "sell a stock when it's first sensed that it isn't acting right."

Well, if I know the average investor, he will sense that his stock "isn't acting right" when the stock goes 1 cent lower than the price he bought it. Hence, it is probably not a very good way to judge stocks.

Instead of such a subjective emotion, there is a more objective measure that professionals have used for decades – the use of the 40-week moving average.

Before we look at the fantastic power of this tool, let's define the terms. A 40-week average is the sum of the past 40 weeks' closing prices divided by 40. Other averages (10-week, 200-day, etc.) are constructed similarly. When this exercise is repeated week after week, this average will "move" and becomes a "moving average."

In the olden days before computers, charting moving averages was a tedious task, but today any one of these averages could be accessed instantly on chart services such as [Globeinvestor.com](http://Globeinvestor.com) or [GlobeinvestorGold.com](http://GlobeinvestorGold.com).

The above was the mathematical definition. My practical definition is that the average illustrates the rate at which money is flowing in or out of a stock. When buyers want to own the stock and are willing to pay more for this security (bid up the price), the average will rise as a consequence.

The opposite is also true: when there are more anxious sellers who would sell at any price, the 40-week moving average will fall.

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Therefore, when a rising 40-week average stops rising and begins to decline it shows that the sellers have gained the upper hand. Of course, since this tool measures the last 40 weeks, this average moves quite slowly, which is both its advantage and its failure.

The average will never give a sell signal at the top. The average could rise for weeks or even months before it turns and begins to descend. But whenever it reverses direction, whenever it turns down, the signal is clear: Get out of the position.

Losses in Bank of Montreal, Loblaw, Citigroup and Bear Stearns call could have been anticipated and prevented by the use of this simple tool. When the average stopped rising, flattened out and then began to fall for these stocks, it was time to “abandon ship.” Did these signals come in time?

Definitely. The 40-week moving average signal for Bank of Montreal (now at \$50.25) came at \$69 on July 27, 2007 to prevent a potential 27-per-cent loss.

For Loblaw, (\$29.44) it was at \$71.65 on July 29, 2005 to prevent a potential 59per-cent loss. For Citigroup (\$26.81) it came at \$50.73 on June 29<sup>th</sup>, 2007, to prevent a potential 47-per-cent loss and for Bear Stearns (\$10.67) at \$147.95 on June 18<sup>th</sup>, 2007 to prevent a whopping 92-per-cent loss.

Is this signal infallible? No. There are occasions when the moving average turns down, but the stock reverses soon thereafter and moves to a new high.

However, such occasions are so rare that it is better to act on the signal, than to subject oneself to a huge potential loss by trying to double-guess it.

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