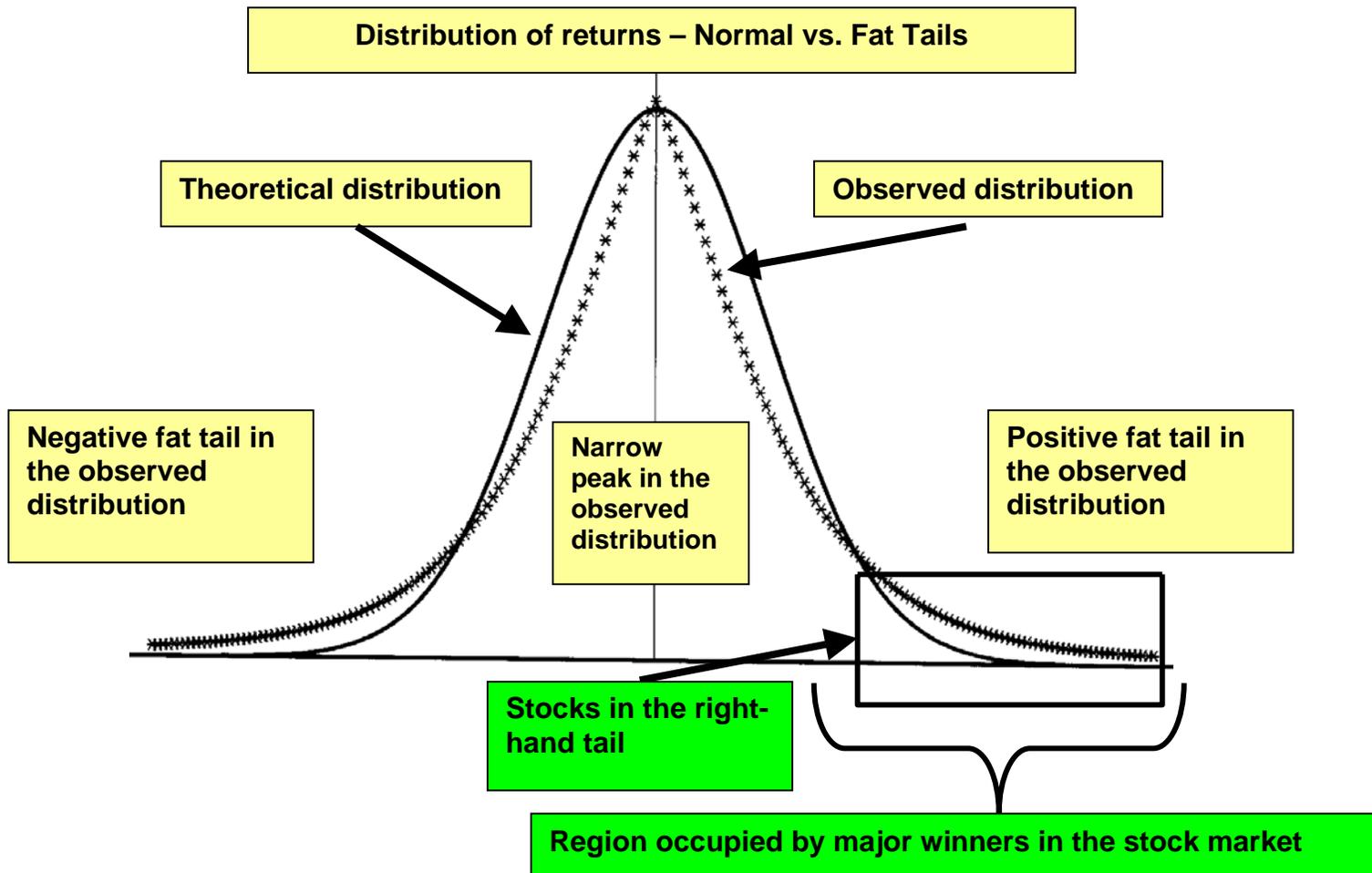


# How to find the big winners in the stock market.

*Big Winners = Stocks in the positive right-hand tail of the distribution of returns*



The far right tail of the distribution of returns is the province of major winners.

As a stock departs from the central part of the distribution the relative strength improves. In my opinion the trend of relative strength gives an early indication of significant improvement before the long-term relative strength ranking systems pick up the change.

Many times the movement away from the center of the distribution will be dramatic and will register as a substantial event in relative strength on the Market Dynamics System. The key question remaining is how long the stock will participate in the far right-hand portion of the distribution. This cannot be known with any certainty ahead of time. As long as the stock performs in the acceptable region it is OK – when the stock falls out of the acceptable region a replacement should be found.

Managing a position in a big winner is somewhat different than managing a less dynamic position.

### ***Big Winners - Returns – best 10% to 20% of all stocks!***

The far right-hand tail of the theoretical normal distribution holds about 2.0% of the total population. In the stock market, recent studies indicate that the region under the curve at the same level of extreme as measured by +2.0 standard deviations holds about 5 to 10 times as many members of the population as the theoretical normal distribution. Therefore the far right-hand tail holds 10% to 20% of the population. Major winners are far more prevalent in the stock market than they would be if the distribution of returns from stocks was an exactly normal distribution.

This is also true for the left-hand tail in that 10% to 20% of the total population lie in the extremes on the left side of the distribution. Major disasters tend to form more frequently than they should if the stock market was distributed in an exactly normal fashion.

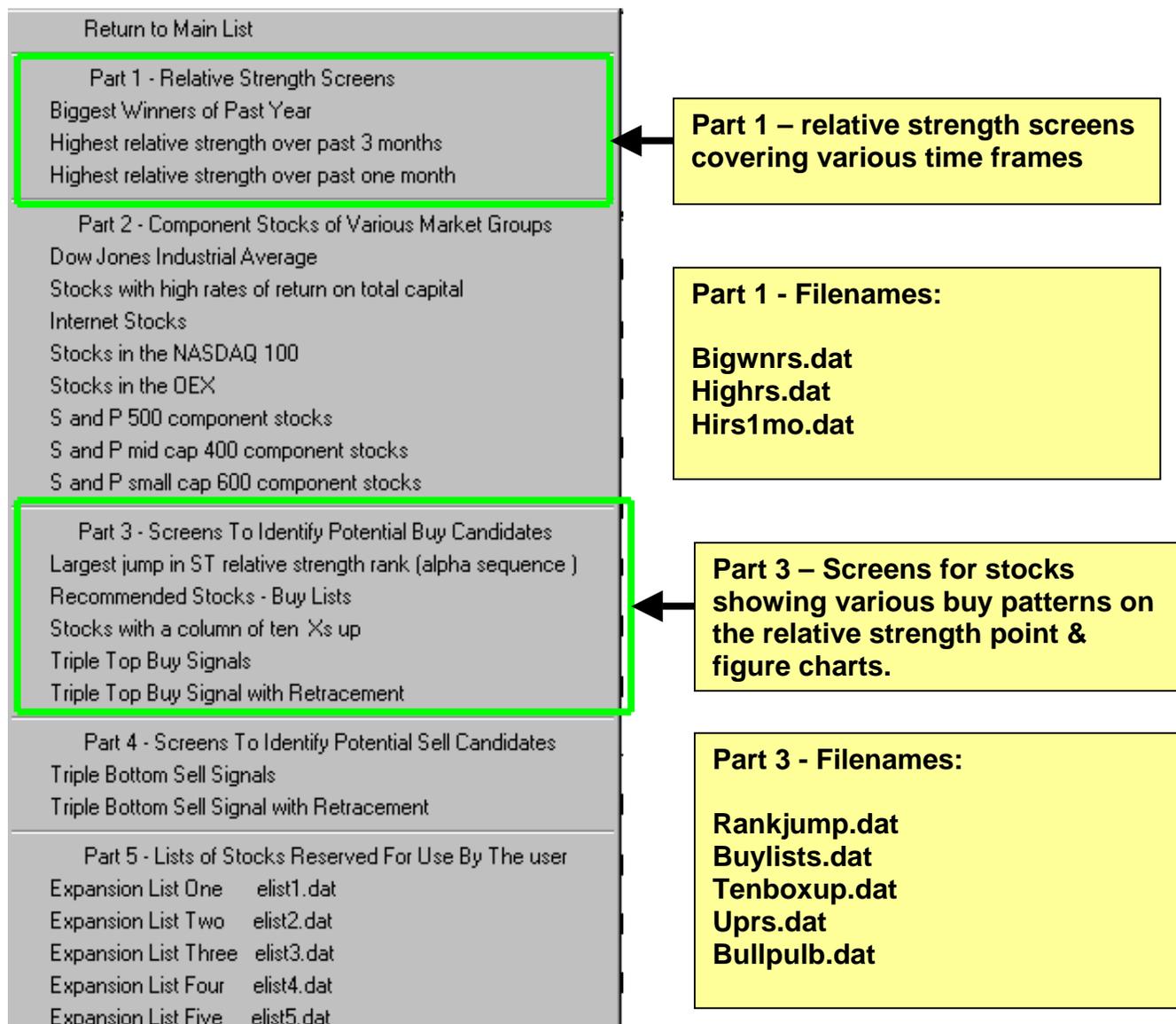
This seems to explain why the stock market follows the Pareto Principle. The Pareto Principle says that approximately the best 20% of a portfolio accounts for approximately 80% of the portfolio's return. This principle has also been called the "rule of retailing".

This observation has extremely practical implications for portfolio management.

1. Stocks in the left-hand tail (left 20%) must be avoided.
2. Stocks in the middle 60% of the distribution are of little interest until they start to out-perform.
3. Stocks in the right-hand 20% of the distribution are the most desirable holdings for the portfolio but only as long as they continue to record excess returns as measured by relative strength.
4. These opportunities seem to exist continuously in the stock market.

Care must be exercised, however, to maintain adequate industry and sector diversification in the portfolio. Many times stocks in the far right-hand tail of the distribution of returns may share common fundamental characteristics. When this is the case these stocks may all reverse direction and turn down together. In highly speculative markets the population of the far right-hand tail will be among the most speculatively priced issues in the market. In the recent major bull market, the relative strength trajectory for many of these issues became nearly vertical and suggested a blow off. Portfolio managers must keep in mind that in highly speculative stocks a reversal of the relative strength trend often occurs very quickly and positions should be sold at the slightest sign of trouble.

**Market Dynamics screens -identify as the movement begins – all of these screens are on the “lists” drop-down menu**



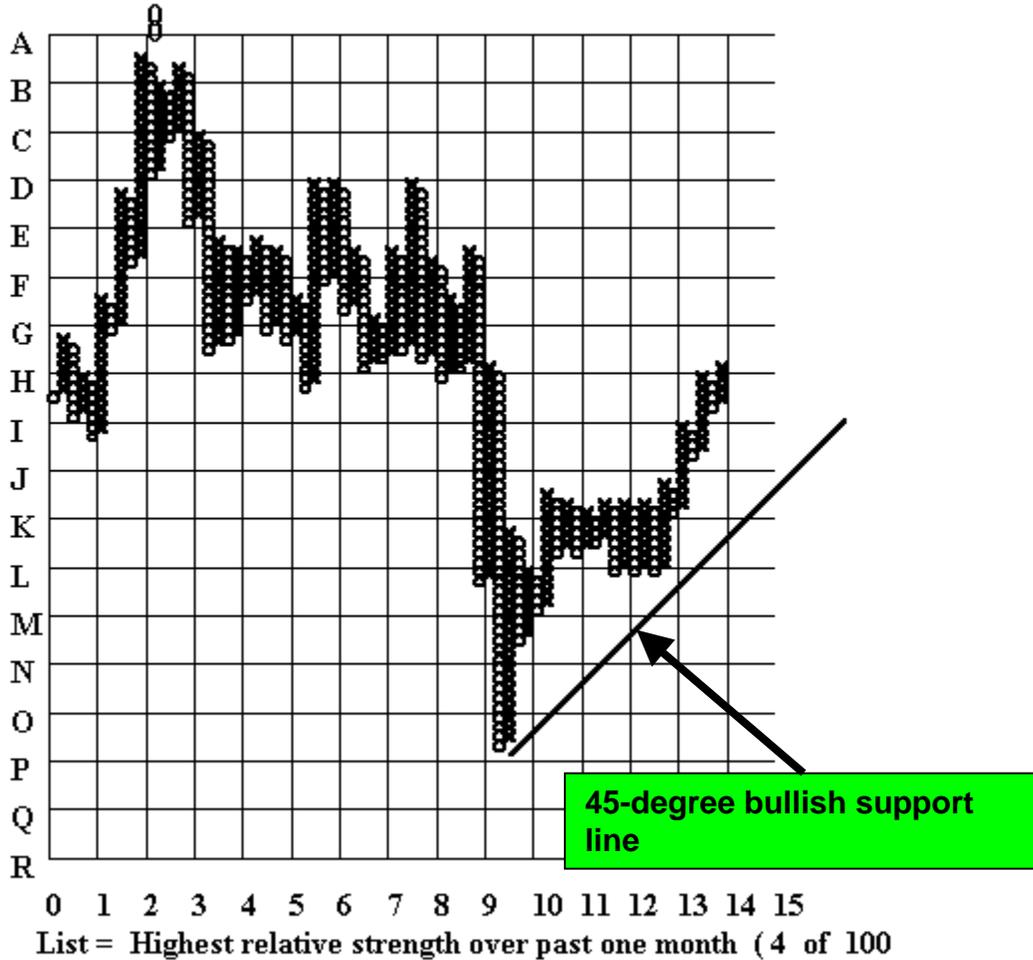
**Most of these screens are prepared and distributed daily with the database update over the Internet. These screens always appear in alphabetical sequence when using the “Lists” drop-down menu on the Market Dynamics System.**

**An effective way to use the screens is to review the screen quickly and when an interesting pattern appears the chart should be sent to the printer for later study.**

**These lists are stored in files in the \MDRS\ folder. The files are text files that are composed of one ticker symbol per line. Some users copy these lists to other systems for review in a different format**

## Highest relative strength over the past month

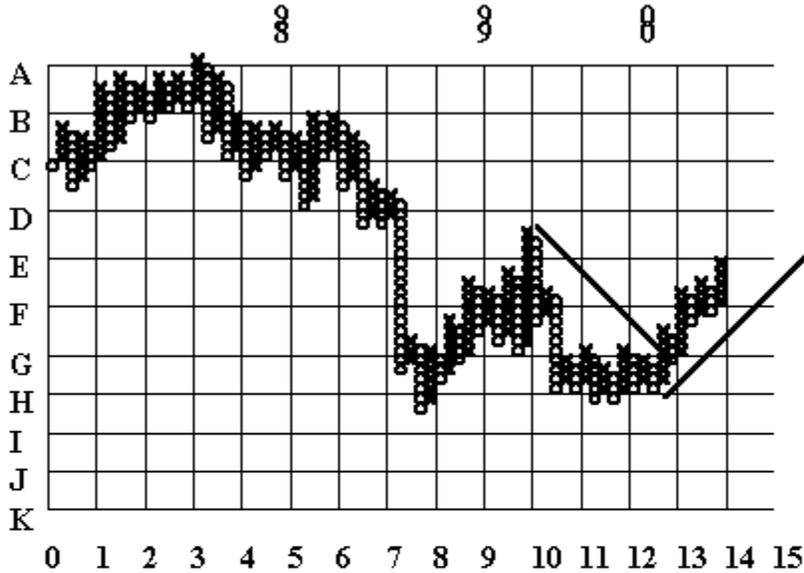
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
AGILE SOFTWARE CORP 06/28/2000 67 AGIL



*This chart is an example drawn from the Market Dynamics screen for the highest relative strength charts over the prior month. This is a list of one hundred stocks and it is updated daily.*

**Highest relative strength over the past three months**

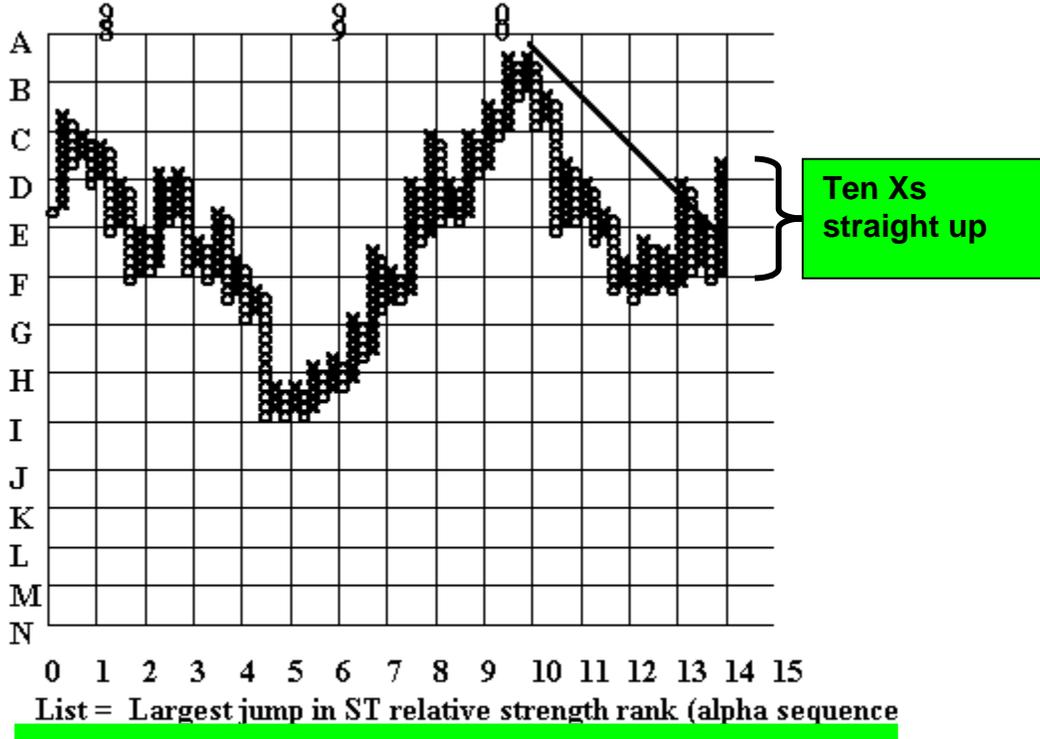
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
COVENTRY HEALTH CARE INC 06/28/2000 14.5 CVTY



**This is an example drawn from the Market Dynamics screen for the best relative strength stocks over the prior three months. One hundred stocks are included in this screen and it is updated daily.**

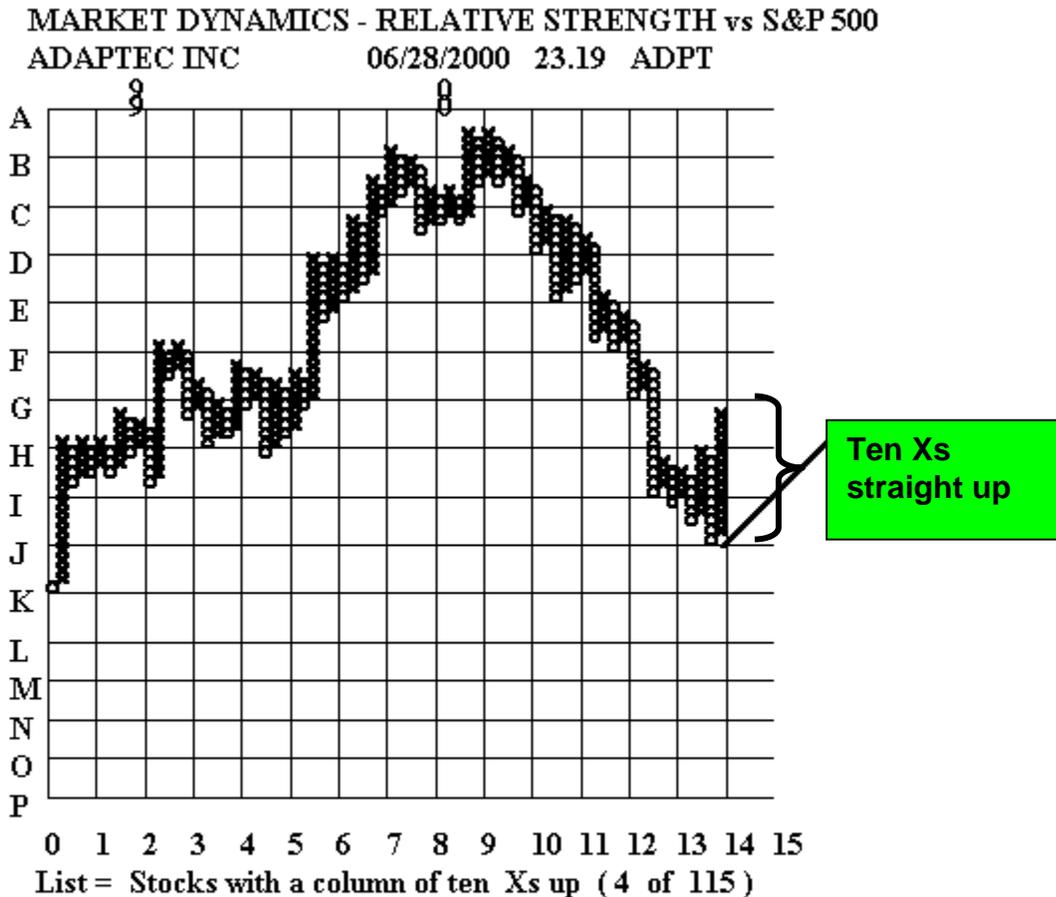
**Highest increase in relative strength rank past three weeks**

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
EGL INCORPORATED 06/28/2000 32.06 EAGL



This stock is an example drawn from the screen that ranks the stocks by the biggest jump in relative strength rank over the past three weeks. There are 50 stocks on this list and it is updated daily.

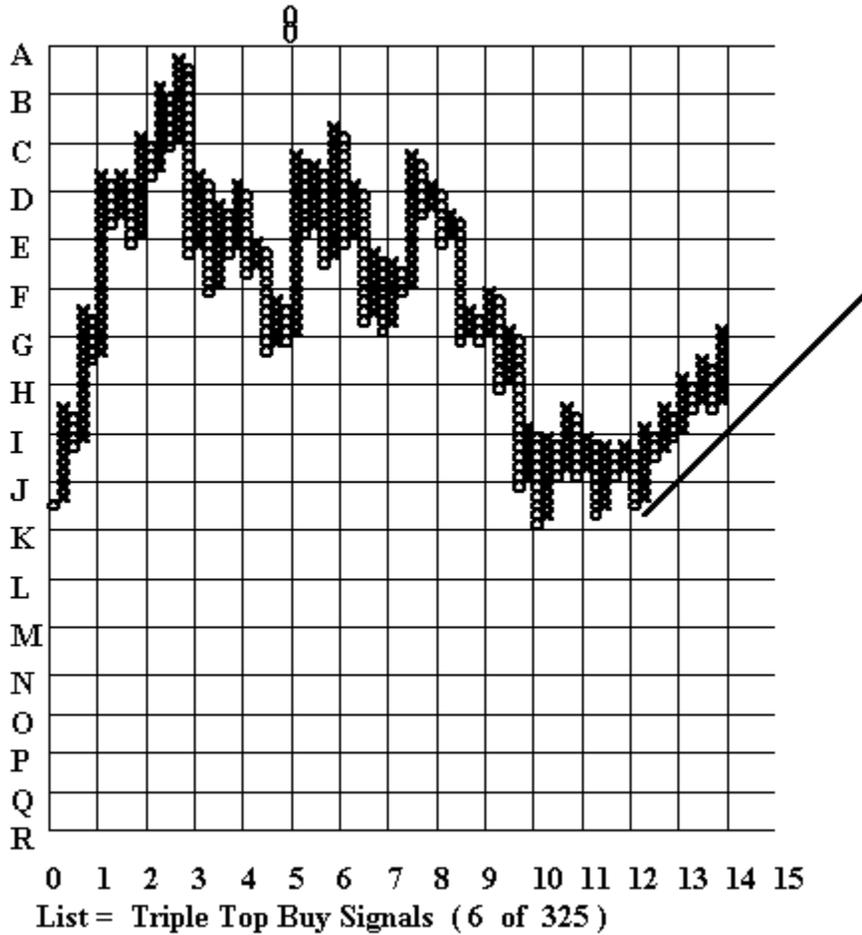
## Stocks with a pattern on ten Xs up



**“Big moves often start with a bang”! This screen identifies stocks with a column of ten Xs straight up. We can’t tell for sure whether the move will continue but at least we know we are observing a dynamic move up. The entire database is scanned for this condition. The list will vary in length depending upon how many stocks meet the condition. The screen is updated daily.**

## Triple top buy signals

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
ACCRUE SOFTWARE INC 06/28/2000 36.19 ACRU



A triple top buy signal is a common condition that is associated with the beginning and development of major up moves. This screen shows all stocks with this buy signal pattern. The list varies in length depending on the number of stocks that meet the criteria.

### ***Best time for entry - during market oversold extremes***

**A stock that can develop a strong buy pattern or high relative strength during a deep oversold condition in the overall market is an attractive candidate for purchase provided it is of average or above average volatility.**

**Oversold conditions can be identified by various oscillators on market averages such as intermediate to long-term Wilder RSI or stochastics. Trend condition indicators that gauge the trend status of a broad list of stocks will also give valid oversold readings at favorable times in the market.**

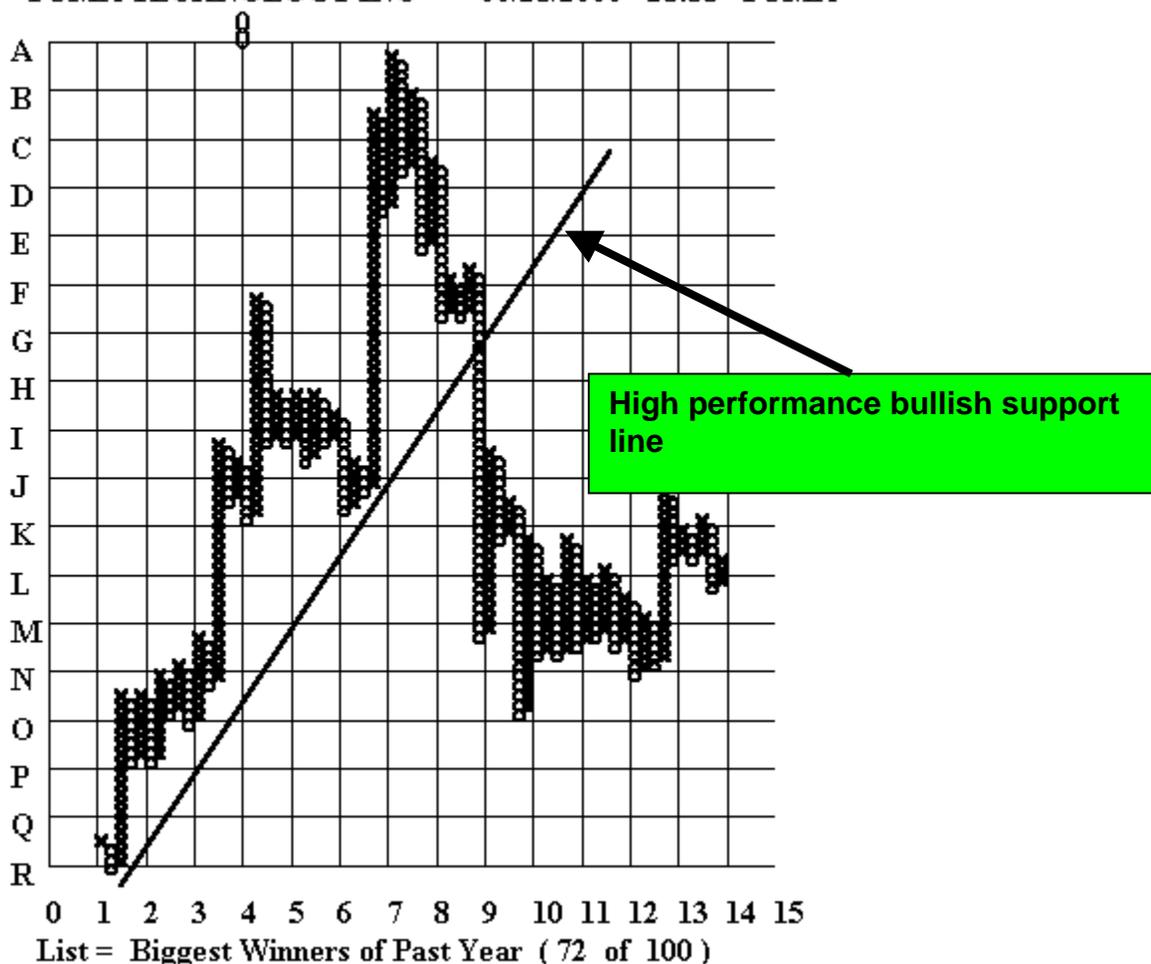
**Stocks that hold up and do well during market declines are very strong stocks and the demand for these shares must be very strong. The exceptions to this rule are low volatility stocks that don't go down because of their low volatility – these are usually thought of as defensive issues.**

**It is probably not good portfolio strategy to delay the purchase of a very strong stock to wait for a market oversold. The entry price may not be improved that much and big winners may get away while waiting for the oversold.**

**Potentially big stocks will usually demonstrate their future performance capability during an oversold condition in the market.**

## Managing the position - Use the High performance Bullish Support line

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
PUMA TECHNOLOGY INC 06/28/2000 28.88 PUMA



Big winners will often run for many columns above the high performance bullish support line. These stocks may have serious corrections and still remain above this line. The volatility of these stocks is usually quite high so the relative strength point and figure chart may cover less than a year. The high performance bullish support line also provides a rough estimate of the risk to support should a correction take place. Should the portfolio manager decide the risk to support is too great - then a sale into strength can be made.

**Managing the position - Use the “rule of nine”**



The “rule of nine” is derived from the literature on Japanese kagi charts. Kagi charts are very similar to point and figure in construction and the “rule of nine” seems to hold for relative strength point and figure charts. It is not a “hard and fast” rule but is based on the frequently observed tendency for stocks to make nine columns that record new highs during a major move up. This example shows exactly nine columns with new highs. The portfolio manager can use this rule to judge the maturity of the trend under observation. After 7 or 8 columns with new highs the stock’s relative strength plot should be watched closely for signs of a reversal or a loss of momentum. If the stock is very volatile and the gain is substantial the portfolio manager may use the “rule of nine” to sell into strength.

## Managing the position - Use up trending channels

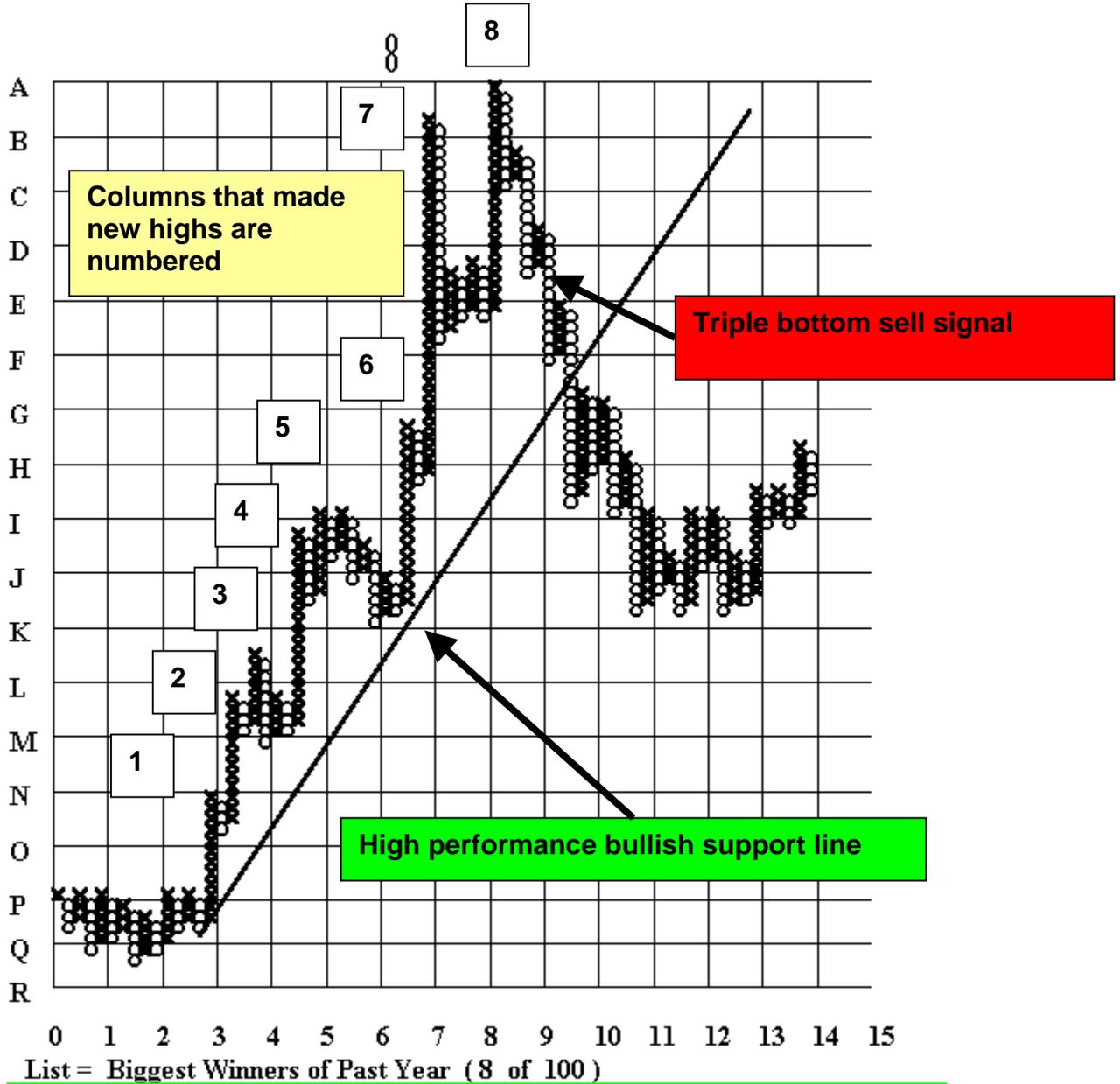
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
HS RESOURCES INC 07/03/2000 31.44 HSE



Upward trending channel lines are a useful guide to taking profits. The move has been significant and the objective is to capture profits while the stock is still strong. Does this guarantee that the stock will reverse – absolutely not – but the objective of taking profits while the stock is still strong has been fulfilled.  
If the upper channel is being touched at a level that matches historic resistance then the sell decision is reinforced.

**Managing the position - Buy on pullbacks if possible**

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
 AVIGEN INC 07/05/2000 42.5 AVGN

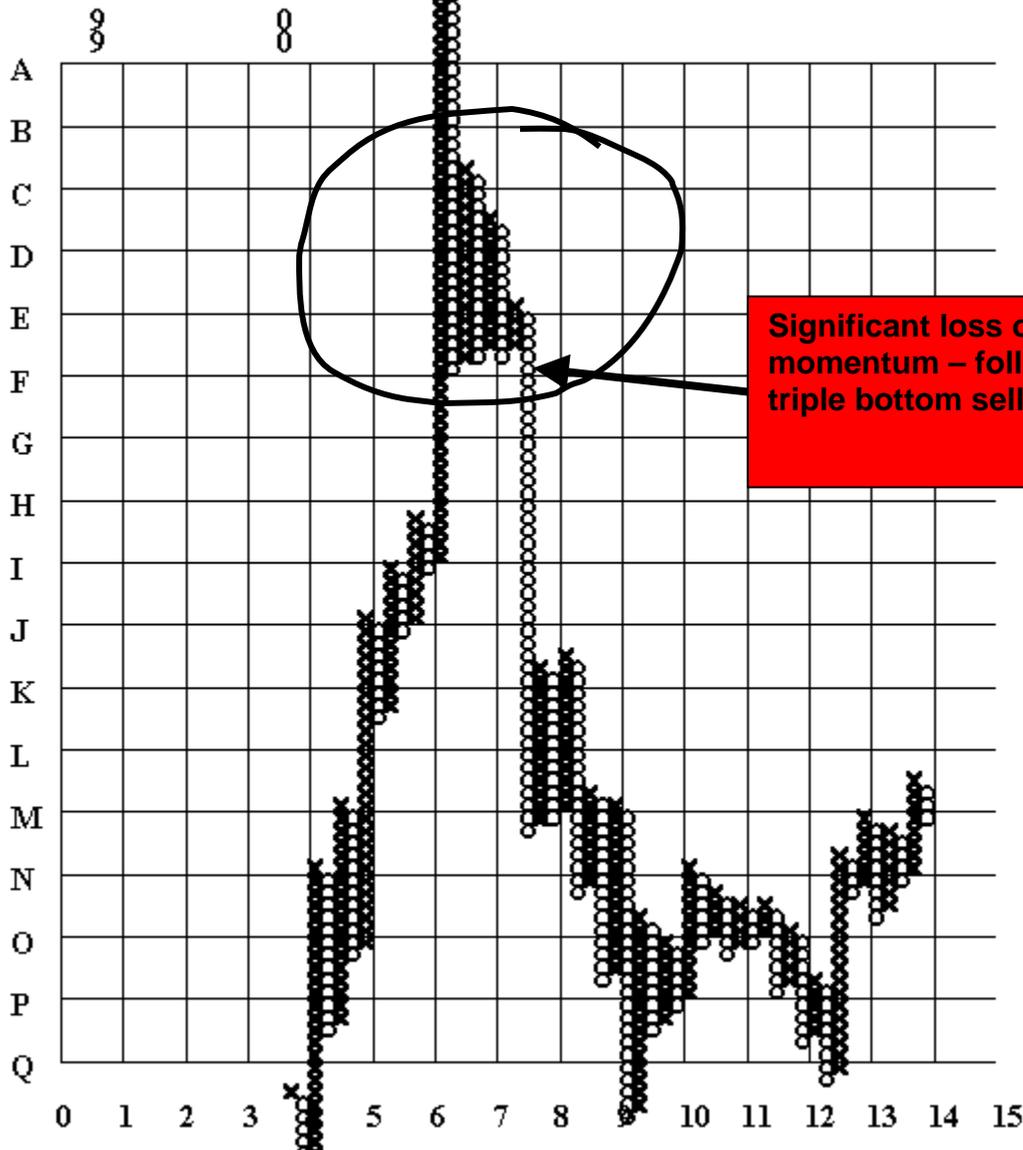


This big winner started its move with an upside breakout at roughly column 3 and ran to the ultimate peak in column 8. There were at least 10 pullbacks that moved the relative strength back toward the HPBSL during the move up. The congestion zone between column 5 and 6 provided an excellent opportunity to buy this stock. The level of the underlying HPBSL always defines the risk of the situation.

This move terminated after 8 columns of new highs. The rule of nine was not far off!

**Managing the position - If trend starts to stall switch to another candidate – loss of upside momentum – correction or reversal?????**

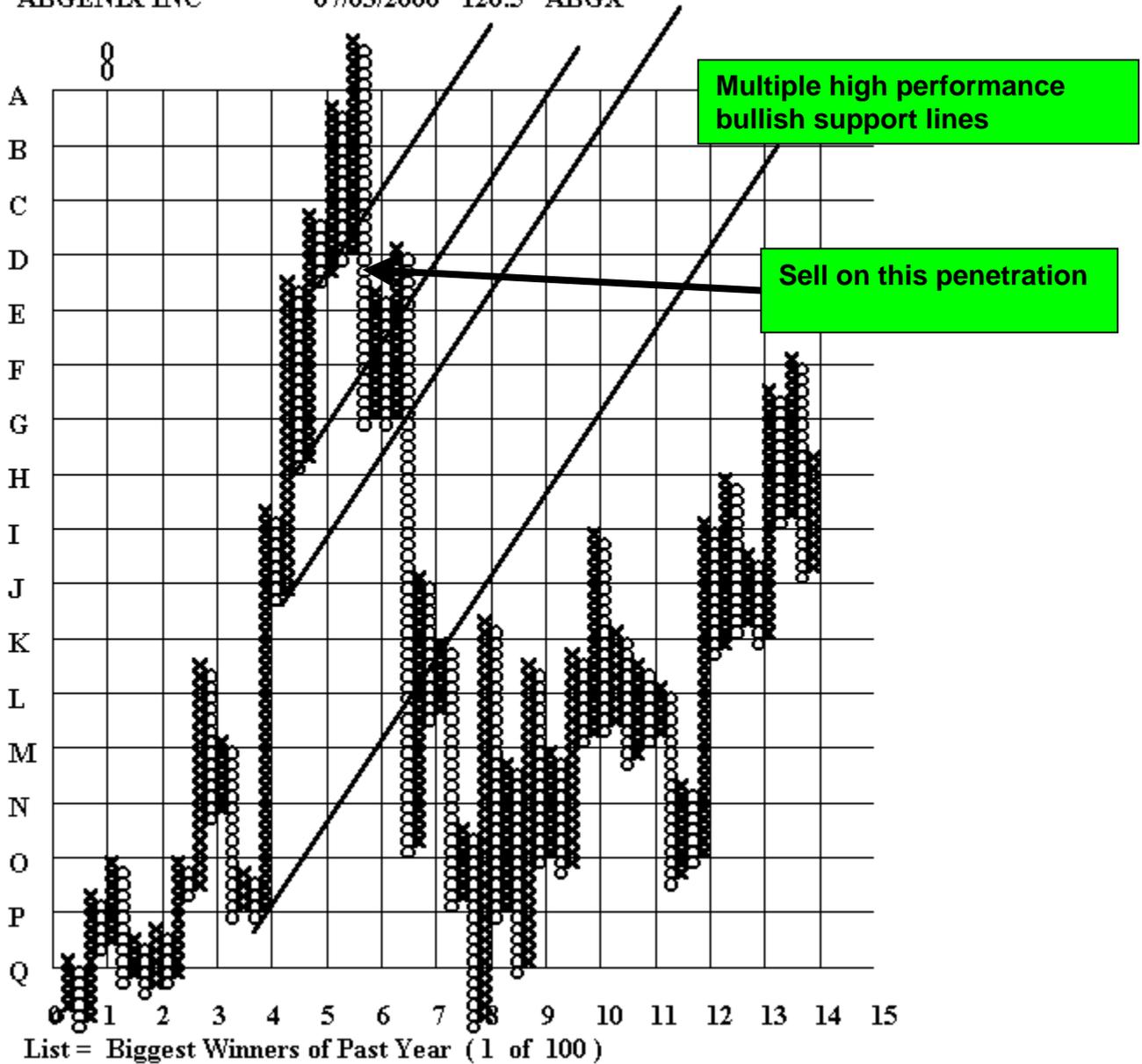
MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
HYSEQ INC 07/03/2000 44 HYSQ



The stock market represents a stochastic process where there are no “hard and fast rules”. The future is almost completely unknown. We just have to operate on the best guess we can muster at the time. Once the opportunity is gone it may be gone forever! We cannot regret that we didn’t sell at the very top. We must be satisfied if we choose to protect a significant profit from the unknown and unknowable future. Profits may disappear and not come back. We don’t want to hastily accept small profits but big gains should be taken at the first sign of trouble! A loss of upside momentum is usually a warning of an impending change in trend.

## When to take profits

MARKET DYNAMICS - RELATIVE STRENGTH vs S&P 500  
 ABGENIX INC 07/03/2000 126.5 ABGX



This chart is shown with multiple high performance bullish support lines drawn as the stock moved higher. This is one way a portfolio manager can “crowd” a big winner and be more or less confident of getting out on the first significant reaction that violates the last HPBSL. Many times the major winners experience a blow-off and a top reversal is formed very quickly. These stocks are speculative “per se” so a quick exit is required to “nail down” the hard-won profits.

## ***Big Winners - Summary***

The best ways to find the big winners of the future are the relative strength screens shown in Part 1 and the buy-pattern screens shown in part 3 of the drop-down menu.

The real problem is how to narrow these lists down to a manageable number.

**Step 1 – Drop all stocks that are locked into trading ranges. These stocks will probably not develop into big winners in the future. Trading range stocks can provide exceptional performance if the trading range is wide enough but probably not very often.**

**Step 2 - Drop all stocks that are mature, well-established businesses that probably won't enjoy enough fundamental improvement to develop into big winners.**

**Step 3 – Concentrate further analysis on stocks that have something new in their fundamental picture – the N in CANSLIM by Bill O'Neil. This could be a new business, new product, new management or some other substantially new development in their fundamental picture.**

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**Time Frames - The upward trajectory for a big winner usually lasts two years – sometimes three. Speculative blowoff up moves will probably be substantially shorter. It is impossible to forecast the length of time required for the big winner to complete its move. You can only track the stock on the relative strength point & figure charts and be ready to sell as the trend reverses direction. Use the upward sloping trend channel to estimate upside targets. Use the “rule of nine” to gauge the maturity of the trend being observed.**

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**High Performance Bullish Support Line - The best tool for the successful management of big winners in the stock market is the high performance bullish support line. The slope of +1.5 provides a high hurdle rate of return to assure performance from the holding. The user is free to apply an even steeper support line that he/she feels is appropriate to gauge the performance of the stock. Slopes greater than +1.5 will probably result in higher turnover but may also increase performance.**

**It must be remembered that managing stock portfolios is a very dynamic process that is not based on scientific mathematical relationships. The effective management of stock positions is more dependent on statistical thinking. Trends run until they reverse and the relative strength point & figure system seems to be an effective observational tool to spot these reversals of trend.**

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