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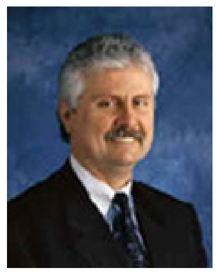
Trading Earnings Surprises Part 2

By Richard Croft Croft Capital Management



Mr. Croft authors a regular Market Commentary column on E*TRADE that appears each Tuesday. He is also a regular contributor to the MoneyLetter, where his articles focus on utilizing individual stocks, mutual funds and exchange traded funds within a portfolio model. Mr. Croft is a global portfolio manager who focuses on risk adjusted performance. He believes it is not just about return, it is about how that return was achieved.

Most recently, Mr. Croft co-authored a Canadian best seller on portfolio building entitled Protect Your Nest Egg. This was Mr. Croft's ninth book.

Last month, we looked at the performance of certain stocks after an earnings surprise. That is where the earnings number came in higher or lower than expected. We noted, in last week's commentary, a study by Lawrence McMillan (www.optionstrategist.com) that looked at stocks immediately following a gap in price as a result of the surprise earnings announcement. What McMillan tried to do was ascertain whether a pattern existed following a gap resulting from an earnings surprise. This concept has appeal, because companies report earnings four times a year, so if it works, there is an opportunity to employ the strategy more than once.

What last month's analysis did not do was take into account the current direction of the overall market. This month's commentary adjusts the performance of the stocks cited in last months commentary, by examining the stock's relative performance to the overall market.

Says McMillan, "There could be a major problem with interpreting the results [as reported last week, if we do not] not take into account what the broad stock market was doing. As we know, the [US] market rolled over into a major correction (although not yet a 10% one) during at least part of this study, so that fact might be the reason that both longs and shorts fell after the initial earnings gap."

In order to remove the effect of the broad market, McMillan adjusted the returns by normalizing them with respect to the S&P 500 Index (symbol SPX). "In simple terms," writes McMillan, "we adjusted the actual percentage moves of these stocks by dividing by the percentage change in SPX over the same time period. This adjustment evened things up somewhat, and we think the following results are a fair assessment of what happened after large gap moves on earnings in the first quarter, relative to how the broad market did."

Table 1 Follow-Through Moves (Raw number and percent)

Normalized For $SPX Moves	1 week	2 weeks	3 weeks
Longs (124)	48 (39%)	50 (40%)	47 (38%)
Shorts (142)	72 (51%)	79 (56%)	89 (63%)

Table 2 Follow-Through Moves (Raw number and percent)

	1 week	2 weeks	3 weeks
Longs (124)	46 (37%)	44 (35%)	36 (29%)
Shorts (142)	77 (54%)	83 (58%)	107 (75%)

Table 3: Average Gain or Loss Normalized For $SPX Moves

	1 week	2 weeks	3 weeks
Longs (124)	–2.1%	–2.9%	–3.5%
Shorts (142)	+1.3%	+2.6%	+5.8%

Table 1 compares directly with table 2 (immediately below) that was taken from last month's commentary. As might be expected, the results for the longs have improved a little and the results for the shorts was not as attractive. That, according to McMillan, "is because the broad market was generally dropping during this time," and table 1 adjusts for that.

In hindsight, only showing the raw number of winners and losers doesn't present a complete picture. We need to also know how big the winners were with respect to the losers. Table 3 takes us to that step, by examining the average results of the 124 longs and the 142 shorts, after one, two, and three, weeks – all adjusted for the performance of the S&P 500 composite index (symbol SPX) during that period.

Note that last month, McMillan stated that the actual returns averaged -11% for longs held three weeks and an average gain of +8% for shorts held three weeks. The normalization procedure dampened the results substantially.

Writes McMillan, *"longs [that were normalized against the S&P 500 composite index] now show an average loss of only 3.5% (not 11%) after a 3-week holding period; shorts now show a gain of 5.8% (not 8%) after the 3-week period."*

The obvious question is whether the S&P 500 composite index is the correct barometer to normalize this data set. In some cases, we are talking about smaller cap stocks, which would not fit the pure definition of stocks in the broader blue chip market.

Typically, smaller stocks are more volatile and because they are not widely followed, are more likely to hit the market with a surprise. But as McMillan points out, "the point of the study is not to determine the best index to represent the subset of stocks that makes big moves on earnings. Rather, it is to see if some discernible trading system can be derived from the data."

To that end, it appears that the optimum strategy is one that looks for stocks that fell (gapped down) after the earnings announcement/ warning, and then take a negative position in that stock. Certainly thatwould be the strategy based on the ex-ante performance of the stocks that gap down.

To be consistent, you should look for stocks where the option volume spiked on the move, and where the initial gap down (i.e. when the announcement was made) was at least 10% below the pre-gap price. In such cases, the study suggests that you can then look for an additional drop of 5% or more from the post-gap stock price over the following two to three week period.

Having said that, I would draw your attention to the lead in of last month's commentary. When stocks gap down, option traders perceive greater risk (i.e. higher implied volatility), and as such, buying an option at that point will cost more. That suggests that traders who buy into the results of the study might want to look at option writing strategies after the initial gap down. That is writing at-the-money or slightly out-of-the-money calls.

That in itself, leads to another caveat. In the options game, traders must always manage their cash flow. The advantage option traders have when playing such a short term high risk game is limited risk. Writing uncovered calls carries with it unlimited risk. So perhaps, the best approach when the stock has gapped down after an announcement, is to employ a bear call spread. That is, write the at-the-money or slightly out-of-the-money call and buy a call that is one or two strikes above. At least with the bear call spread, the worst case scenario is defined at the outset.

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Timely Trades April 15, 2009

By Steve Palmquist

NASDAQ Outlook & Key Trading Levels:

The market moved up less than a point on low volume during Monday's session as it approached horizontal resistance, and the upper Bollinger Band. During Tuesday's session the market pulled back from resistance by twenty seven points on average volume. On Wednesday the market continued the retrace from horizontal resistance and moved into the open gap area created on 04/09 before bouncing back and closing up about a point.

The trading plan was to be taking profits on longs since the market had run up to horizontal resistance, and the upper Band. The plan would consider new longs on a break above the 1665 area; or shorts on a strong volume break below the short term ascending trend line, drawn through the lows of 03/09 and 04/01. Since the market did not break above the 1665 area and instead retraced to the short term ascending trend line, I followed the plan by taking profits on existing longs and not picking up new positions.

It is interesting that even with the market's retracement from resistance, which is by definition the typical action, we saw several long setups trigger. EEFT, FDS, ISLE, and STP all moved past their trigger points. It is nice to see our setups have action, even when the market is near resistance. I passed on these trades because the market was just under horizontal resistance and the upper Band. Since the normal thing for the market to do at resistance is base a bit, or retrace, I do not want to load up on longs and take the risk that they pull back with the market.

Trading is about risk management, not setup entries. Longs carry higher risk when the market is just under resistance so I usually pass on them in this situation; unless I see something trigger on at least 150% of average volume, which indicates unusual interest. Some subscribers took these trades. There is nothing wrong with that, as long as traders understand that the trades are higher risk than normal and are comfortable with that. Different traders have different tolerances for risk, and will make minor adjustments to the trading plan based on their own risk tolerance.

At this point the market has two basic options. It can continue retracing, or it could bounce off the short term trend line and make another test of the horizontal resistance level at the top of the trading range. Volume usually indicates the interest level in a move, so if the market drops below Wednesday's low on above average volume I will look at a couple of shorts. If the market moves below Wednesday's low on light volume I will stand aside and give it another day or two to get serious about a move.

If the market drops below Wednesday's low on light volume I will be standing aside and looking at the next key level, which is the 1550 area. A move below the 1550 area, on volume, would also make a couple of short trading positions interesting. If the market dropped below the 1550 area on light volume, the next area to generate interest in shorts would be 1474. If the market drops below the 1474 area I will be focusing on shorts, a few if the move is on light volume and more if the move comes on strong volume.

Since the market has tested horizontal resistance and pulled back, a strong volume bounce here would be interesting. A light volume bounce would be more likely part of a basing process, a strong volume bounce may break through horizontal resistance. If the market bounces, and moves above Wednesday's high on above average volume, I will look at one or two strong volume longs. I do not want more than one or two until the market breaks above resistance, and I am only interested if a bounce from current levels comes with strong volume.

If the market breaks above the 1670 area without extending above the upper Band I will take a few more long trading positions. If the market stays above the 1670 area, and volume starts increasing, I will add more trading positions. If the market can move clearly above the 1670 area then it would be showing a double bottom pattern. If this move came on volume it would be time to focus on trading longs and avoiding shorts.

Since the market has not yet confirmed a double bottom pattern, by moving above the 1670 area on volume, we are still in a trading range environment. In trading range environments, I only trade part of the account and focus on taking profits when stocks move to the Bands, or key support/resistance areas. If the market breaks out of this trading range, and forms a clear pattern of higher highs and higher lows (the definition of an up trend), then I will look at increasing holding times and position sizes.

There are no risk free trades. I want to manage risk by looking at each setup and asking, 'what is the lowest risk way to enter this trade?' I then want to compare that risk to what my other choices are. I am not focused on one stock, I am looking to manage units of risk by looking at all available trades, the various entry techniques, and the potential risk to reward that each trade yields. I then take the best of what is available, within the constraints of the trading plan. I do not focus on watching for triggers to within the penny. I am looking at all the potential trades and then picking the ones that are best. Additional trading tips and techniques are available at www.daisydogger.com. You can also request a current copy of the Timely Trades Letter, which includes market analysis, swing trading setups, and trading tips based on 20 years of market experience, by sending an email to sample@daisydogger.com.

Long Trade Opportunities:

Focus on Long setup's that hit the price trigger when the market is bouncing off support, breaking above resistance, or in a clear up trend. See information on Market conditions above to determine if longs are appropriate. Do not take positions just because they reach the price target, check volume and market conditions to determine if taking a position is appropriate. An Initial protective stop loss is typically placed just below the low of the pattern. If the set up does not trigger the next day, watch the pattern for a few more days. Interesting Long set ups include:

CRAY on a move above 4.61. Accumulation

GPS on a move above 14.966. Pullback.

RGR on a move above 12.06. Pullback.

Shorting Opportunities:

Focus on Short setup's that hit the price trigger when the market is retracing from resistance, breaking below support, or in a down trend. See information on Market conditions above to determine if shorts are appropriate. Do not take positions just because they reach the price target, check volume and market conditions to determine if taking a position is appropriate. An Initial protective stop loss is typically placed just above the high of the pattern. If the set up does not trigger the next day, continue to watch the pattern for a few days. Interesting Short set ups include:

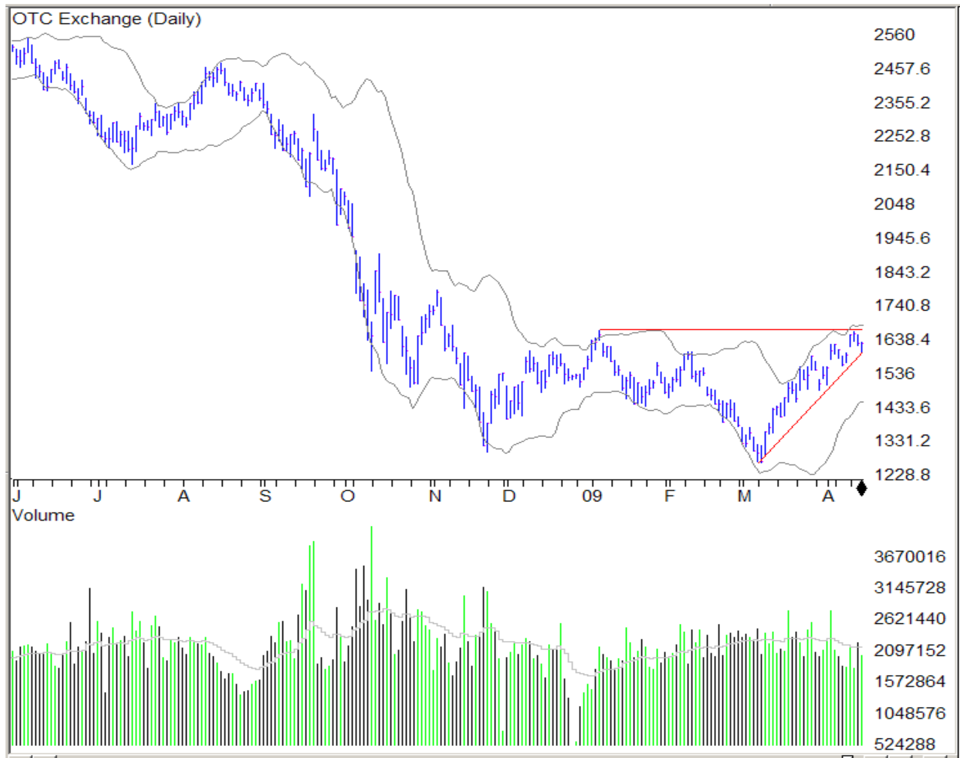

Figure 1 NASDAQ Market

AVAV on a move below 22.84. Retrace.

ALKS on a move below 8.08. Distribution.

HAE on a move below 49.84. Flag.

Trader Tips:

I typically focus on Swing trading when the Market is trading in a wide range. A narrow range market doesn't provide enough room for Swing trades to work, and a trending market is usually more favorable to Intermediate term trading. A wide range is defined in terms of both the number of days it typically takes to get from one end of the range to the other, and the number of points between the top and bottom of the range.

If it typically takes less than four days for the market to move from one end of the range to the other I will favor Short-term trading over Swing trading. It usually takes at least one day in order to know that the market has bounced off support or resistance, which leaves at least three days of a favorable environment for the Swing trade to work if the Market is trading in a range at least four days wide.

I also look at the number of points between the upper and lower boundaries of the range and the average number of points the Market travels in a day. If the Market is trading in a 100-point range and it typically moves about 20 points a day, then there is plenty of room for a swing trade to capture a move. If the Market is trading in a 60-point range and typically moves about 20 points a day, then there us usually not enough room for Swing trades to work.

Finding good swing trading set ups

is fairly straight foreword. However, just taking every trade that comes along will lead to mixed results. The leverage in Swing-trading comes from learning to time the trades with the rhythm of the Market. This requires spending some time in the school of hard knocks, and learning to focus on the charts; not emotions or CNBC.

When the Market is trading in a base the best time to take new swing-trades on the Long side is when the Market bounces from the bottom of the base. New Short trades should be taken when the Market retraces from the top of the base. The middle of the base is the 'no zone', avoid new trades in this area and manage existing trades instead.

Sometimes the top and bottom of a basing area are flat, making it easy to tell when the Market is approaching support or resistance. Frequently the top and bottom of the base slopes which makes it a little harder to tell if the current swing has reached the upper or lower boundary of the base.

In practice it is often best to close positions as the Market approaches support or resistance rather than trying to time the exact top or bottom.

Market conditions are the most reliable 'indicator' which is why I start there every evening to determine if the current conditions are suitable for trading, and if so what style.

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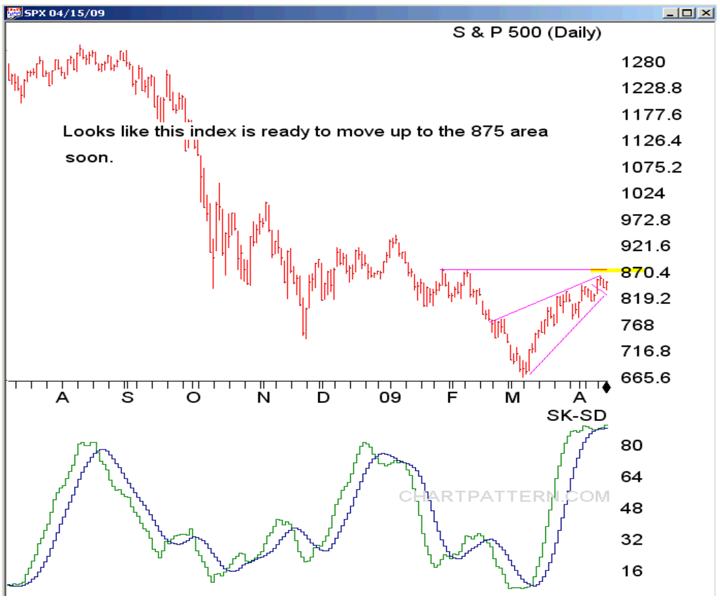
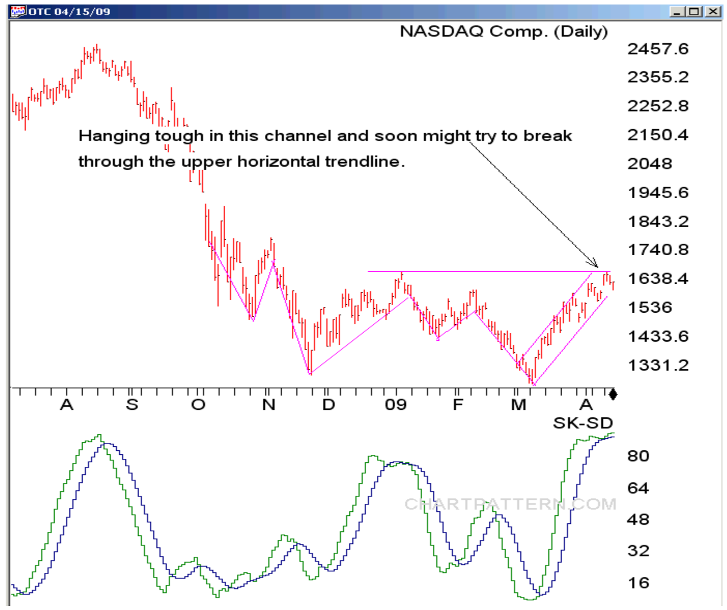
The Zanger Report April 15, 2009

Hello out there stock fans. A gap down opening today that was the bottom of the day as financial stocks slowly built up momentum into the close. Anticipation of leading bank stock J.P. Morgan (JPM) reporting earnings premarket tomorrow drove the upward momentum.

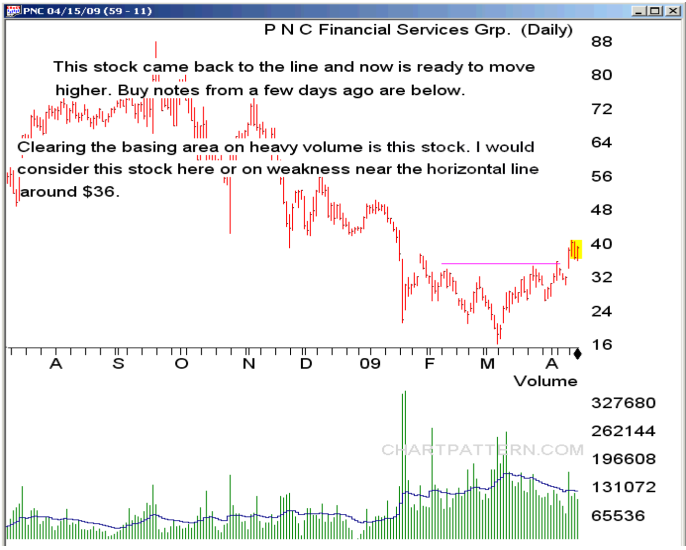
Let's see the leading averages that closed up strong suggesting tomorrow could be an up day.

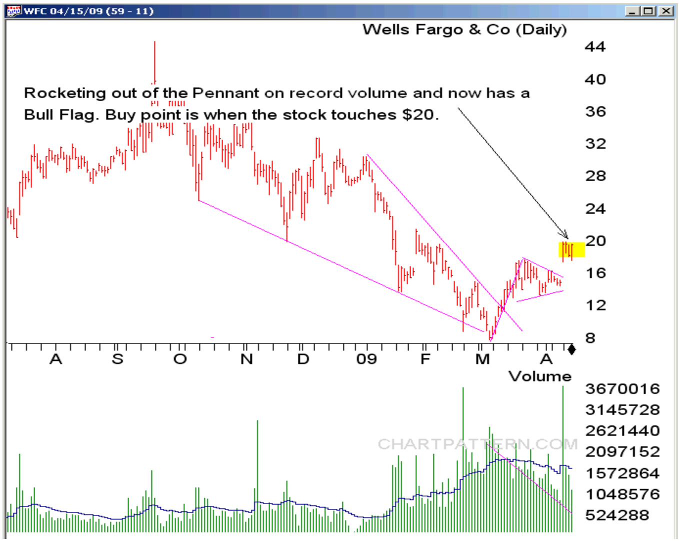


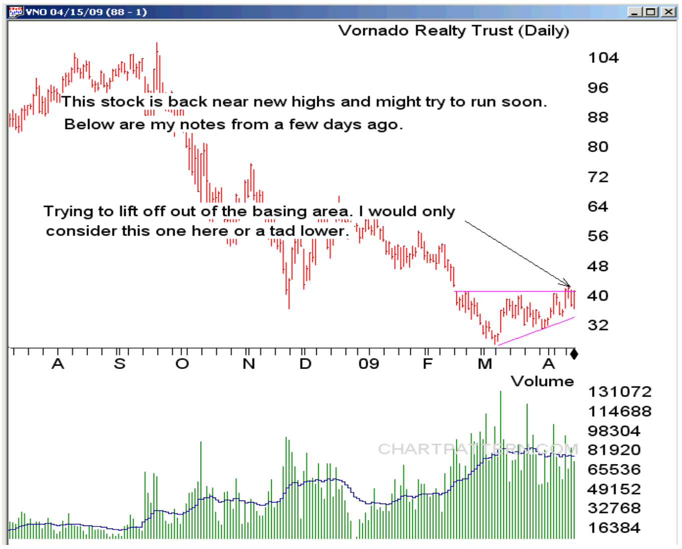


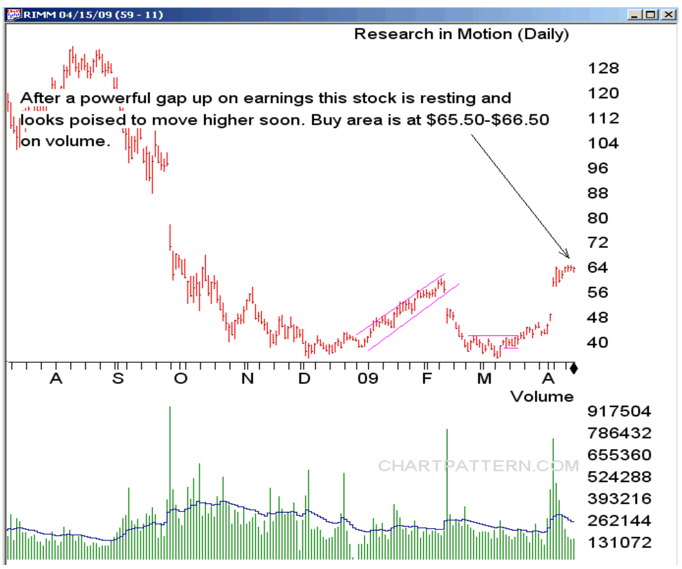
My short term trading oscillator closed the day at plus 36. This leaves the market with plenty of room to move.

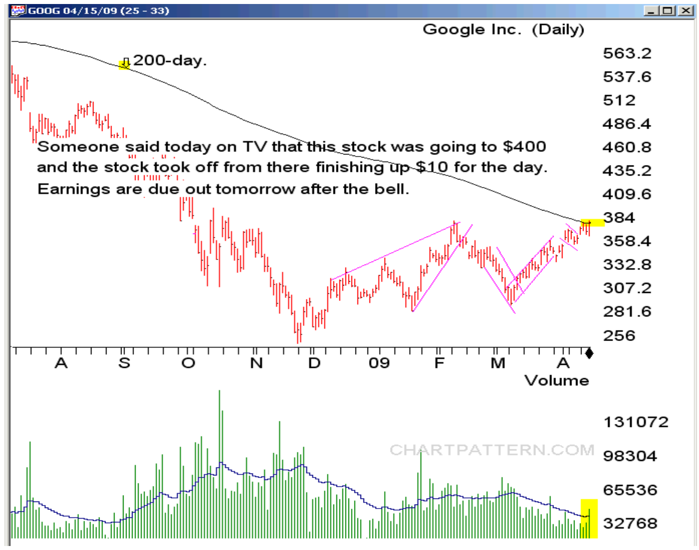
Now on to some stocks that look poised to move up soon. Banks and RIETs look best tonight.

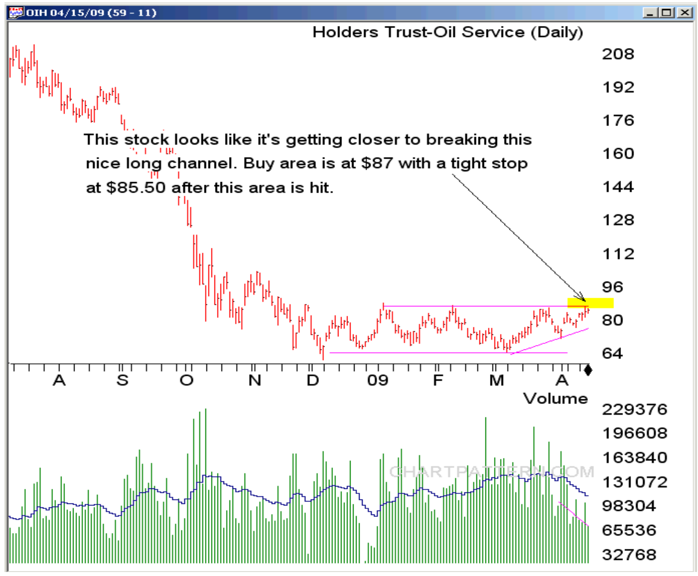












About the Author:

Dan has been featured in FORTUNE MAGAZINE and appeared on a segment of EXTRA TV. He was also the weekly host of his own half-hour show on the Business Channel in LA and featured in numerous leading trade magazines such as Active Trader, TradersWorld, Forbes and Stocks & Commodities.

Dan has been an AIQ user since 1992 and uses AIQ's advanced list feature in charts for his daily stock screening. More info on Dan's newsletter can be found at Chartpattern.com.

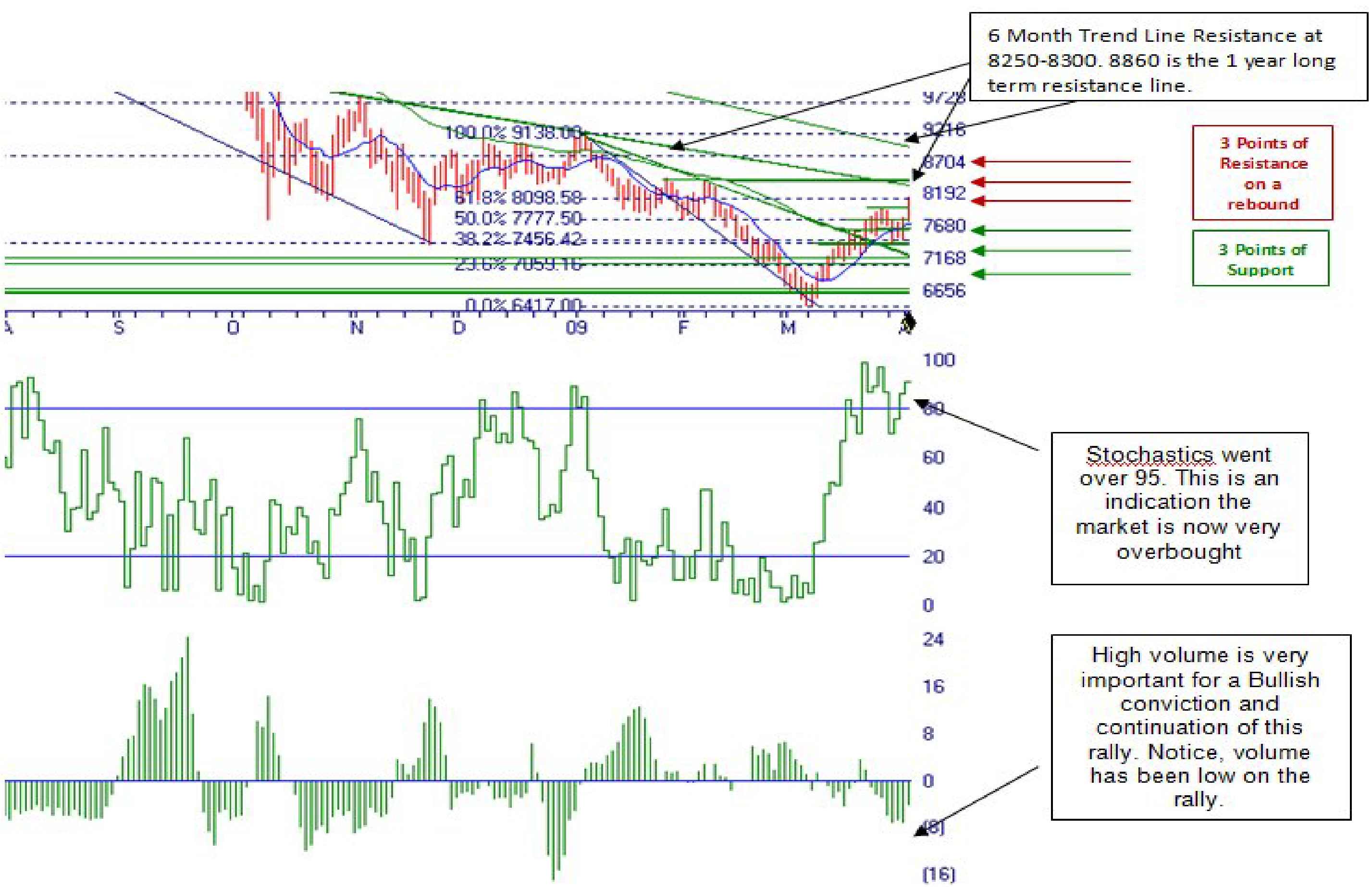
Bartometer Market Outlook, April 1, 2009

By Joe Bartosiewicz, CFP, Devon Kay Financial Group

The market has now risen about 23% from the lows of March 9th and we are now overbought short term. Long term we are putting in a bottoming process and the market is still relatively cheap on a long term basis. Last week I stated that I believed the market was overbought but could go to the 8098 level. We hit our 61.8% Fibonacci resistance at 8098 and sold off. The market is still very overbought short term and I am very aware of the 6 month resistance line in the market of 8250-8300 and 8700+, and 848 on the S&P 500.

If we break out of the 8250-8300 area on the Dow and 848 on the S&P 500, short sellers might get spooked and push the market up to the 8700 area or 900-940 area on the S&P. Earnings are coming out over the next 2 weeks and are expected to be bad, if earnings are not as bad as expectations, the market should see through that bad news and continue to rise hopefully through the 8300 level and to the 8800 level. The question we are all asking would be if this is a bear market rally or the start of a major leg in a new Bull market? We will see, but most of my technical analysts with which I speak and my own work is saying that although the market is overbought with resistance at 8250-8300 my technical's as well as technical analysts who I corroborate believe the rally can last for a while longer.

The 10 day moving average composite has successfully crossed the 50 day moving average. Over the past 50 years of back testing this indicator has worked well as to buying when it crossed on the upside and selling when it crossed to the downside. I will monitor this and other indicators as to when to get more bullish or bearish. Right now it is somewhat bullish. I do feel that fundamentally we have hit a low, but if you have a nice profit on certain equities, I would take a little off the table. I would think about adding to positions on any selloff to the 7400-7500 area. If you are not in at this time I would not put all of my money targeted for the market at this time. I would average into the market over the next few months or on selloffs. This market is driven by technical's not fundamentals. **Support on the Dow Jones is at 7220, 7177-7150, 7077, 6938 and 6611. Resistance is at 7220, 7385, 7451, 7680, and 7775**



Market Strategies

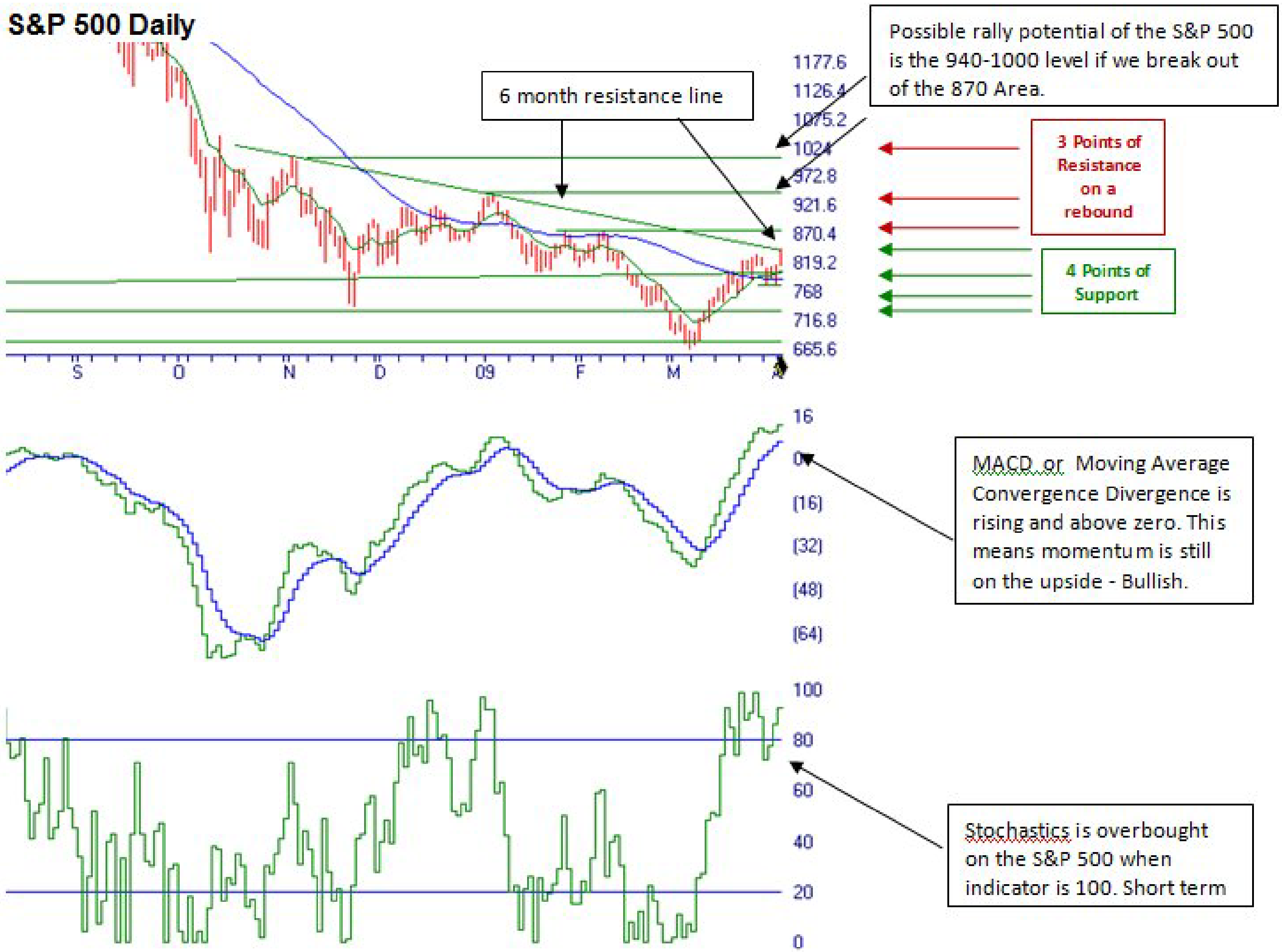
My market models are NEUTRAL TO SOMEWHAT BULLISH BUT BE AWARE THAT THE MARKETS ARE OVERBOUGHT AND WE COULD HAVE A SELLOFF AT ANYTIME: LONG TERM I FEEL THE MARKET WILL RISE. I AM OPPORTUNISTIC ON THE LONG AND SHORT SIDE.

WE ARE STILL IN A TRADING MODE

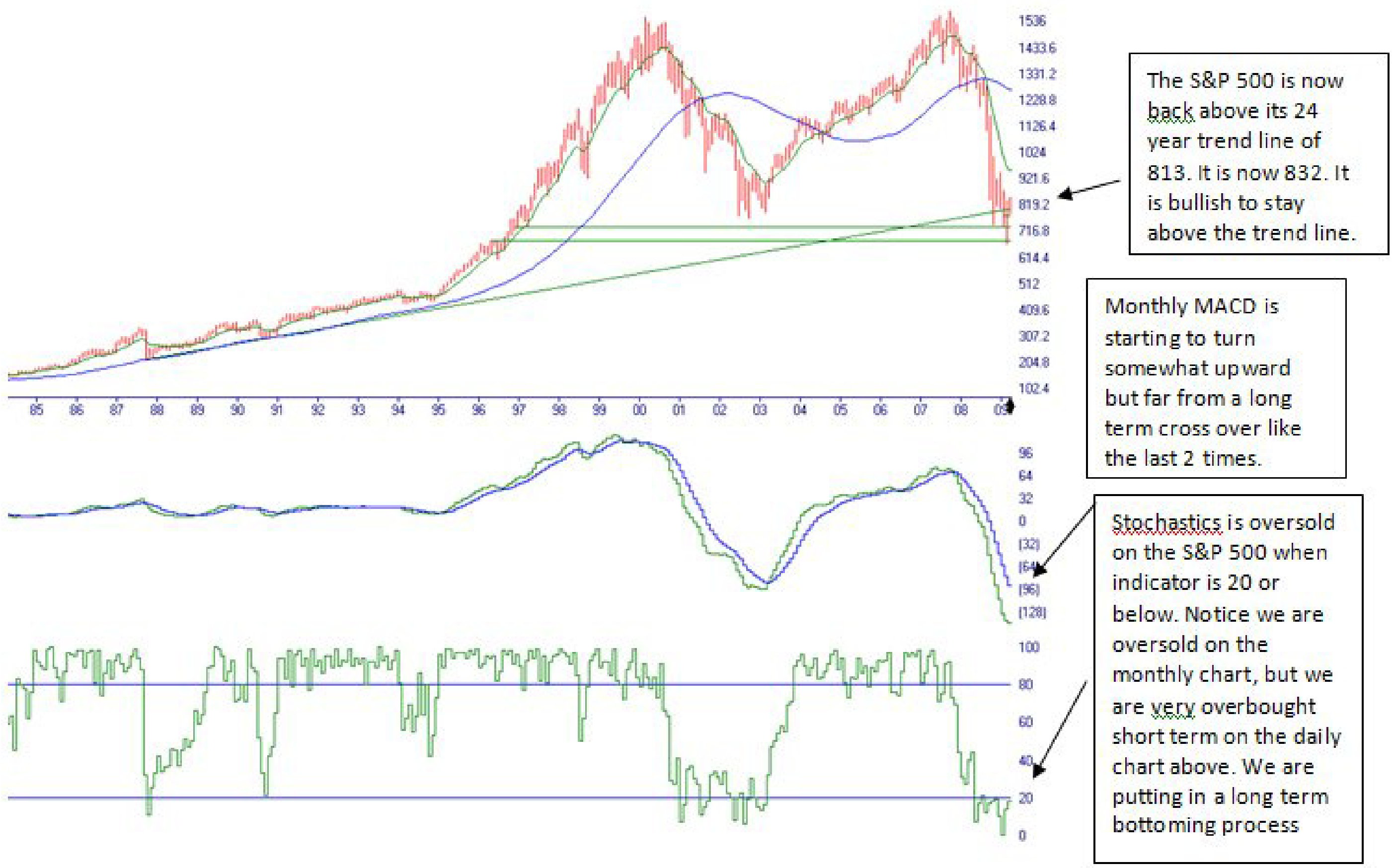
SUPPORT ON THE S&P is 832, 817, 805, 800, 789, 780
RESISTANCE is at 851, 877, 900, 919, and 941.

This market has a projection now that is possible as stated last week to 880-940 level on the S&P. It is valid for as long as we stay above 816 on a close. Observe the resistance points mentioned above for possible selling or support levels to go long. Always place your stop orders if markets go against you.

*Technical Analysis is based on a study of historical price movements and past trend patterns. There is no assurance that these movements or trends can or will be duplicated in the near future. It logically follows that historical precedent does not guarantee future results. Conclusions expressed in the TA section are personal opinions: and may not be construed as recommendations to buy or sell anything.



S&P 500 MONTHLY CHART



We are bottoming and one year from now unemployment might still be high, but the stock market is anticipating a recovery now like it usually does. Volume has been low on the rally. This rally is not sustainable unless volume picks up. Too many people are out of the market and if the news over the couple of weeks is not as bad as expectations the market can continue to rise. If the news is very bad the market should sell off to the 7400-7500 level.

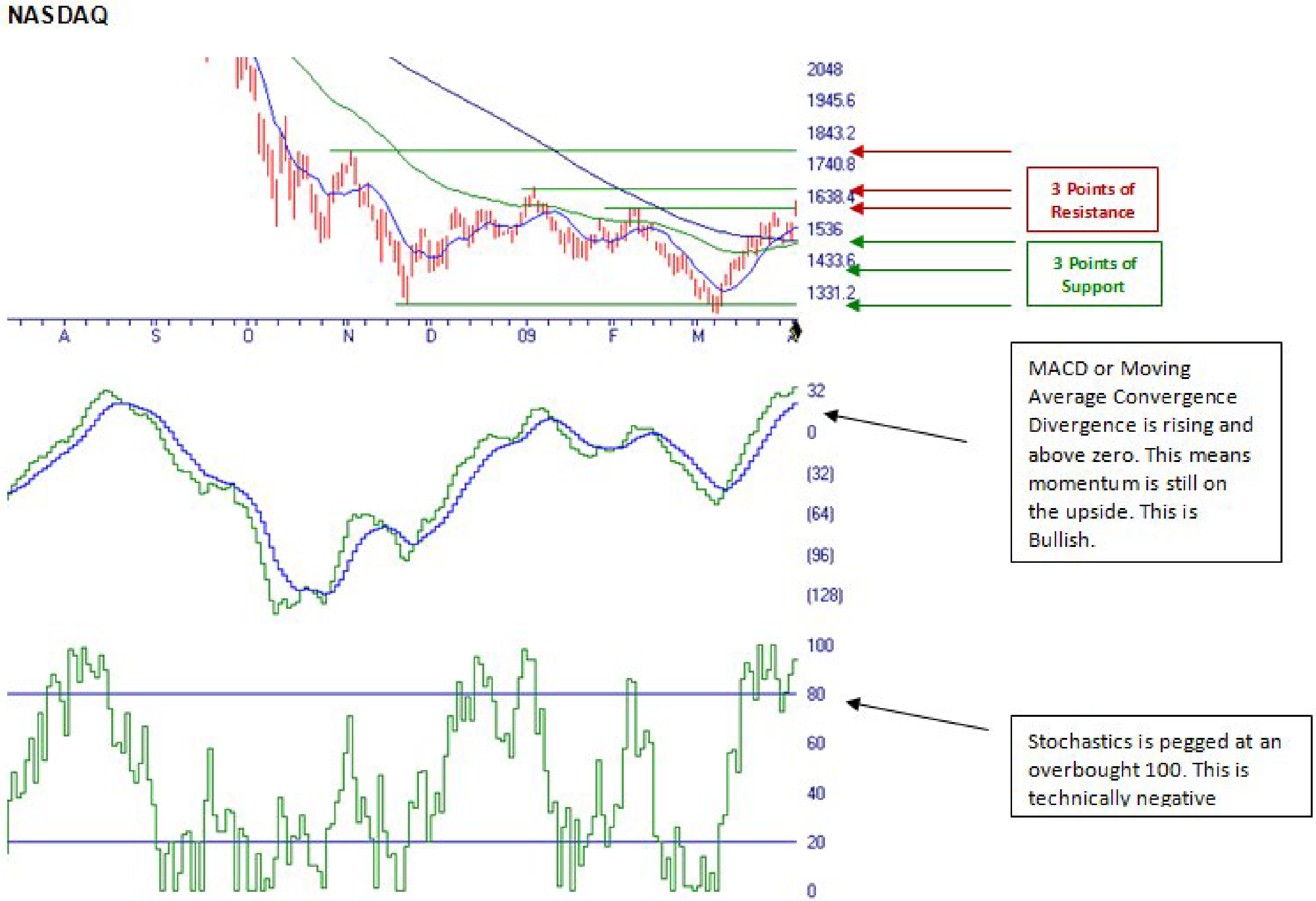
NASDAQ

There is support at 1601, 1554, 1492, and 1454. There is resistance at 1635, 1671, and 1785. Commodities and energy plays need a little rest, but I am bullish on this sector.

TECHNICALS

My technicals have brought in some mixed and overbought results this week. These numbers are for the Dow Jones, and no other index.

- (MACD) has crossed to the upside (positive)
- Volume accumulation percentage has turned positive.
- Volume is low on the rally this is somewhat negative
- The Hi-Lo index is going up positive.
- Point and Figure Charts is positive.
- Money Flow is positive.
- Stochastics is overbought short term
- OBV overall is neutral
- Overall, most technical information is positive but the market is overbought.



Conclusion:

My computer models are NEUTRAL to Moderately bullish, but I am prepared for a quick selloff at anytime as earnings announcements are coming out over the next 2 weeks. Earnings are expected to be pretty bad so as long as earnings are not worse than the already low expectations, the market should hopefully see through the bad news and continue its rise. If earnings are worse than market expectations the market can have a quick selloff and I will probably add to my positions if the market sells off to the 7400-7500 area. This market is very overbought short-term but it is still putting in a bottoming process long term. One caveat, if the 10 day moving average composite falls below the 50 day moving average composite whenever if happens, I will become more Bearish. Up until then, I am still in the market and more positive than negative.

Contact Information: Joe Bartosiewicz, CFP. Investment Advisor Representative 5 Colby Way, Avon, CT 06001 860-404-0408

Joe is a Investment Advisor Representative, a Certified Financial Planner and a Registered Principal specializing in increasing individual wealth through individual and corporate investment management, estate, retirement planning and tax savings strategies for over 29 years. Joe Bartosiewicz, Jr. is the founder and president of Devon Kay Financial Group, an organization that promotes and presents financial seminars and workshops for businesses, associations and individuals. Over the years, he has presented hundreds of public and private financial seminars to audiences throughout Connecticut.