

Using Abnormal Activity to Predict New Upward Trends

Buying Strategy

By Tyler Bollhorn, Stockscores.com

Concept

Information affects stock price. The more important the information, the greater the effect on price. Recognizing that there are market participants who act on information that has not yet been made public, we can often predict the arrival of significant news by monitoring market activity. Statistically significant abnormal activity is often an indication that positive new information is becoming a factor in the market.

Background

The most important factor affecting stock price is. As information about the earnings potential of a company is made public, prices move to reflect the new knowledge. Often, stocks move in advance of the public release of information because there are market participants who have access to the information early. In other words, the process of information dissemination is gradual and not always fair.

Fortunately, this process often shows up in market activity. If significant new information is available, those with access to that information at an early stage may buy or sell in the market. In doing so, they can cause abnormal market activity.

For example, if an individual learns that Company A is likely to announce an alliance with Company B that will have significant impact on Company A's bottom line, that individual may decide to purchase shares in Company A. If there are enough people with enough buying power, they can cause the price of Company A to move significantly, and trade an abnormal amount of volume.

Mathematically, we can define what a normal price move for a stock is based on its past trading history. A stock like Microsoft may move up or down 3% on average in a day. A smaller, more speculative stock may have a greater range of price movement. Based on their specific trading history, it is possible to extrapolate an expected range of price movement for the next trading session. If that stock moves outside of that range, it is deemed to have made an abnormal price change.

We can apply the same reasoning to the quantity of stock traded on a particular day as well. If a stock trades far beyond the average number of shares that it has traded historically then, statistically, it has traded an abnormal number of shares.

Identifying stocks that make statistically significant abnormal price movements while trading an abnormal quantity of shares is an excellent clue that the market is trading on significant new information. That information may have been made public, market participants may be making an educated guess on future information, or privileged market participants are trading on private information. In certain situations, stocks that behave abnormally are often telegraphing future price trends.

Identifying stocks that have made statistically significant abnormal price gains is an excellent way to find stocks that may continue into up trends. However, using only this filter is insufficient as you will simply find too many candidates and a success rate for finding winners that is too low.

Recognizing that price volatility defines uncertainty, we also want to focus on stocks that have recently been in a period of low volatility, relative to the past trading history of the stock. Market participants are confident about the value of a company that shows little volatility. In other words, the market is confident about the price it has given to all available information. Therefore, if a stock breaks from this period of low volatility with an abnormal gain, we hypothesize that the move was motivated by new information. This new information will take the stock higher as more people learn about it.

If the stock makes this abnormal break out of a period of low volatility with strong volume support, we have even more evidence that there is new information causing some investors to get excited. Consider the following example:



Chart 1 On the most recent trading day, this stock has made a statistically significant gain, with abnormal volume. Notice that the stock is breaking out of a trading range, and is showing more volatility than it had shown recently. This is a sign of a stock that is trading on something new and significant, and may indicate an up trend is possible in the short term.



Chart 2 - soon after, this stock went into a strong upward trend as more investors learned of the significance of the new information. It seems that the abnormal breakout was the first indication that there was something positive happening with this stock.

The concept of resistance is very important to this strategy. When looking at a stock chart, it is relatively easy to see that there are price ceilings that seem to prevent a stock from moving upward. In our previous example, that ceiling is at about \$55. This line of resistance is really just a boundary above which the market is unwilling to pay. Based on

all the information that the market has about a company, the market is unwilling to pay more than the resistance price.

Therefore, if a stock breaks above resistance, it may imply that there is new information that makes the company worth more, and therefore, the market is prepared to pay more.

Therefore, the logic of this strategy is as follows. Identify stocks that are behaving abnormally to the upside and trading abnormal amounts of volume because that is an indication that there is something positive happening. If the stock is moving from a period of low volatility, we can assume that the market was confident about the valuation it has given the stock. Further evidence of new information is found if the stock breaks from this period of low volatility and above a line of resistance to prices beyond which the market was previously unwilling to pay.

Criteria

- Set **Abnormal Activity** to **Abnormal Day Up**. This will filter out all the stocks that have made a statistically significant abnormal return. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- Set **Candle** equal to **Bullish Candle** as we want stocks that closed well on the day of their abnormal trading. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- Set **Volatility Index Yesterday** to **Low** to allow only stocks that have been trading in a period of low volatility to be filtered. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- Set the **Short Term Consolidation** and **Medium Term Consolidation** to **Yes** as this will further restrict the volatility requirement. This indicator selects the stocks that are consolidating into trading ranges, and demonstrating a reduction in volatility and, therefore, increased confidence in market price. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- We want to find stocks making breakouts, so set the **80 Day Resistance** to **Breakout**. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.
- Volume is an important component to this strategy. Select **Yes** for **Today Relative to 20 Day Volume Average**. This filter is found under the Volume Indicator Queries section of the Stockscores.com Market Scan tool.
- To filter out stocks that have poor liquidity, also set a minimum volume requirement. What amount you use depends on what priced stocks you are seeking, but 25,000 shares is a good minimum to use here. Set **\$ Value Volume >= \$250,000**. This filter is found under the Volume Indicator Queries section of the Stockscores.com Market Scan tool.

Variable Criteria

- You may want to restrict your search to stocks that are above or below a particular price. Use the **Price >=, <=** tool to do this. This filter is found under the Price Indicator Queries section of the Stockscores.com Market Scan tool.

Visual Assessment

It is very important to gain some experience in identifying resistance and stocks that are breaking through resistance and out of trading ranges. By inspecting the stock chart, you want to eliminate stocks that are facing important resistance and focus on those that have broken out of trading ranges through a major level of technical resistance.

We also want to avoid stocks that have already made significant gains recently, as they are too risky. So, if the chart shows a stock that is breaking out to a new high for the third or fourth time in the past couple of weeks, you may have a stock that is trading on too much euphoria and is therefore too risky.

Where It Can Fail

No strategy is risk free, and this one is certainly no exception. Sometimes, a stock will break out on the expectation of certain information but fall back quickly when that expectation is not met. Investors using this strategy have to maintain a high level of discipline and cut losses short. As a general rule, the line of resistance that the stock broke through when it made its abnormal gain becomes a line of support. If the stock breaks back below this support line, the implication is that the information that caused the breakout is no longer valid. Therefore, the reason for buying the stock is no longer valid. Cutting losses early and at the point that support is penetrated is essential for success over the long term. Consider this example:



Chart 3 – This stock made an abnormal move upward, broke through resistance and trade abnormal volume. However, it soon penetrated its new support and trended lower. Smart investors would take their small loss when it went below the \$93 level. Dumb investors would hold the stock all the way down.

Summary

Abnormal market behavior often precedes significant corporate developments. By scanning the market for stocks that are making abnormal gains, and breaking out of trading ranges with strong trading volume, we can find stocks that may be setting up for a strong upward trend. Maintaining a disciplined approach and cutting losses short when proven wrong can be combined successfully with this strategy to make abnormal profits in the market.