

HOW TO RECOGNIZE SELL SIGNALS

Sell Rules: **Climax Tops**



How to Recognize Sell Signals

Selling can be one of the trickiest parts of investing. Part of the problem is that most people don't have any sell rules at all. This is a big mistake I learned the hard way when I was just starting out. I had picked the big winners of the cycle during a market uptrend, but I let my profits slip away until I ended up just even for the year. After doing an extensive analysis on what I did wrong, I came up with some basic sell rules to guide me in the future.

There are 3 main reasons to sell a stock: 1) protect capital; 2) lock in profits; 3) reduce exposure due to market distribution.

Keep All Losses Small

Protecting capital should be your first priority. If you lose heavily, or if you get too far in the hole, it becomes increasingly difficult to just get back to even. Your defense is to cut your losses while they are small, 7-8% from your purchase price. The fact is you aren't going to be right on every stock; you might not even be right on half of them. But if you keep your losses small, you won't get too hurt and you'll live to fight another day. Now the stock might come right back up after you sell, which can be frustrating. But don't decide you're just going to ignore the rule next time. The rule is in place to protect you from a catastrophic loss. It keeps your loss small and manageable, instead of letting it get large and disastrous. Our number one sell rule is that you must always cut losses at 7-8% from your purchase price, no matter what. This is the absolute maximum, the average of your losses should actually be less.

Lock In Your Profits – Recognizing Climax Tops

Now let's move from defense to offense. How do you lock in your gains when you find yourself with a big winner? In my experience it is often best to sell a big winner while it is still advancing and looks strong. The common fear is "what if it goes up more without me?" That may happen, but remember, your goal is not to sell at the very top price. That's almost impossible to do. Rather, you just want to participate in the majority of the move.

One of the easiest ways to sell a big winner into strength is to learn to recognize a climax top. A climax top occurs in many big winners where the stock has already run for a number of months then suddenly takes off and runs up much faster. There is euphoria surrounding the stock as investors become willing to pay increasingly higher prices for the stock because they "must" have it in their portfolio. This huge demand is unsustainable and when investors realize their mistake, the stock will usually come down very hard, and quickly. The tech bubble of 2000 had many examples of climax tops, but it wasn't the first. You could see the same action during the Dutch tulip bulb craze in 1637 or the South Seas bubble in England in 1720.

Here are a few signs that will help you recognize a climax top so you can sell while the demand is still hot, rather than waiting until everyone is heading for the exits.

- After already making a move up 18 or more weeks out of a first or second stage chart base, the stock suddenly accelerates. In many cases it will rise 25-50% in just one, two or three weeks.
- Many times on the daily chart, you'll see the stock go up seven out of eight days, or eight out of ten days in a row. Often, one of the days will be the largest daily point gain of the entire move. On a weekly chart, the stock will often have the largest weekly price spread, from low to high, of the entire move.
- Often the demand will be so great for the stock that it will create an "exhaustion gap" where the stock's lows for the day are higher than the previous day's highs. It is important that this occurs after the stock has already made a significant move.
- Excessive stock splits can be a signal that a climax top may be near. Either with a high frequency of splits, two or more in the last year or so, or high split factors, such as 3-for-1 or 4-for-1 stock splits.
- On a weekly logarithmic chart you can draw an upper channel line over several months, connecting the highs of at least three points. When the stock breaks above this channel line, it is a sign the upward move is getting out of control.
- You might also see a wide weekly spread followed by a week that retraces the same wide spread, from its low to its high, with volume remaining high. It shows up as two parallel vertical lines we call "railroad tracks."

With all of the above signals, it is important to remember that they occur after the stock has already made a significant move.

While the climax top is one of the easiest to recognize it can be emotionally difficult to sell during this period. After all, you will be making a lot of money as the stock makes these huge point gains. By sticking to your rules, you will come out ahead as you preserve your profits rather than watching them vanish quickly.

As always, you can see more educational examples in *Investor's Corner* in IBD®. Plus, visit our web site, Investors.com, to view more samples in the education section and the *Daily Stock Analysis* video.

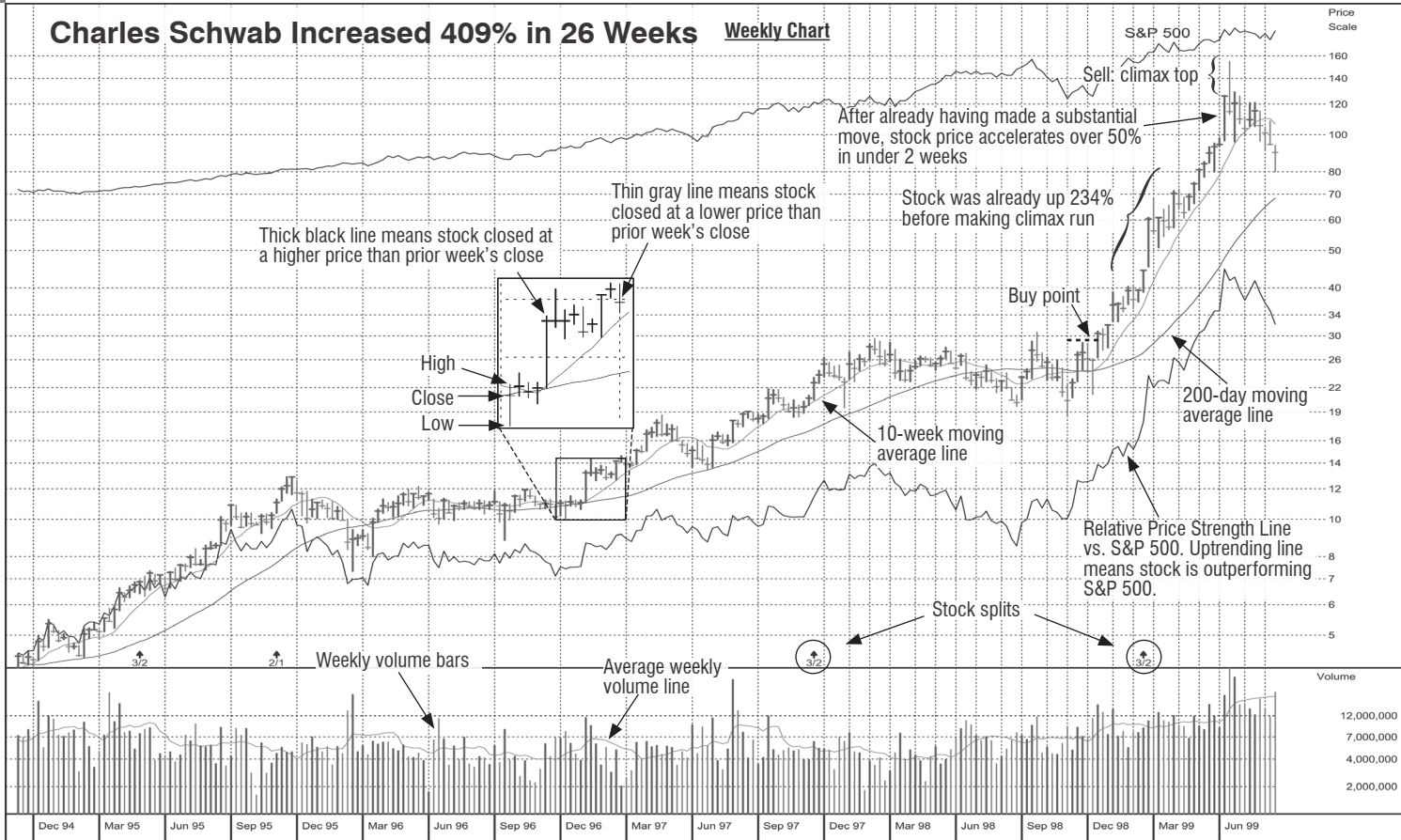
The charts on the next two pages give you definitions of key features included in IBD chart examples. You can use them as additional references as you go through this booklet.

We look forward to helping you become a more successful investor.



William J. O'Neil

Charles Schwab Increased 409% in 26 Weeks Weekly Chart



6/18/1999

Charles Schwab

Daily Chart

Daily charts show some signals that can't be seen on a weekly chart. For example, 7 out of 8 days up, exhaustion gaps, etc.

Stock was up 7 days in a row and had the largest daily point gain (up over 10% in one day)

Exhaustion gap

It can be very thrilling holding on to a stock during a climax run. You will be making a lot of money very quickly. But you must follow the rules and sell into the strength

Stock dropped 38% from the top in just a few days. You have to act fast or you will lose your profits quickly

Relative Price Strength Line vs. S&P 500. Uptrending line means stock is outperforming S&P 500.

Daily price action

50-day moving average line

200-day moving average line

Daily volume bars

Price Scale

150

100

50

Volume

1,600,000

800,000

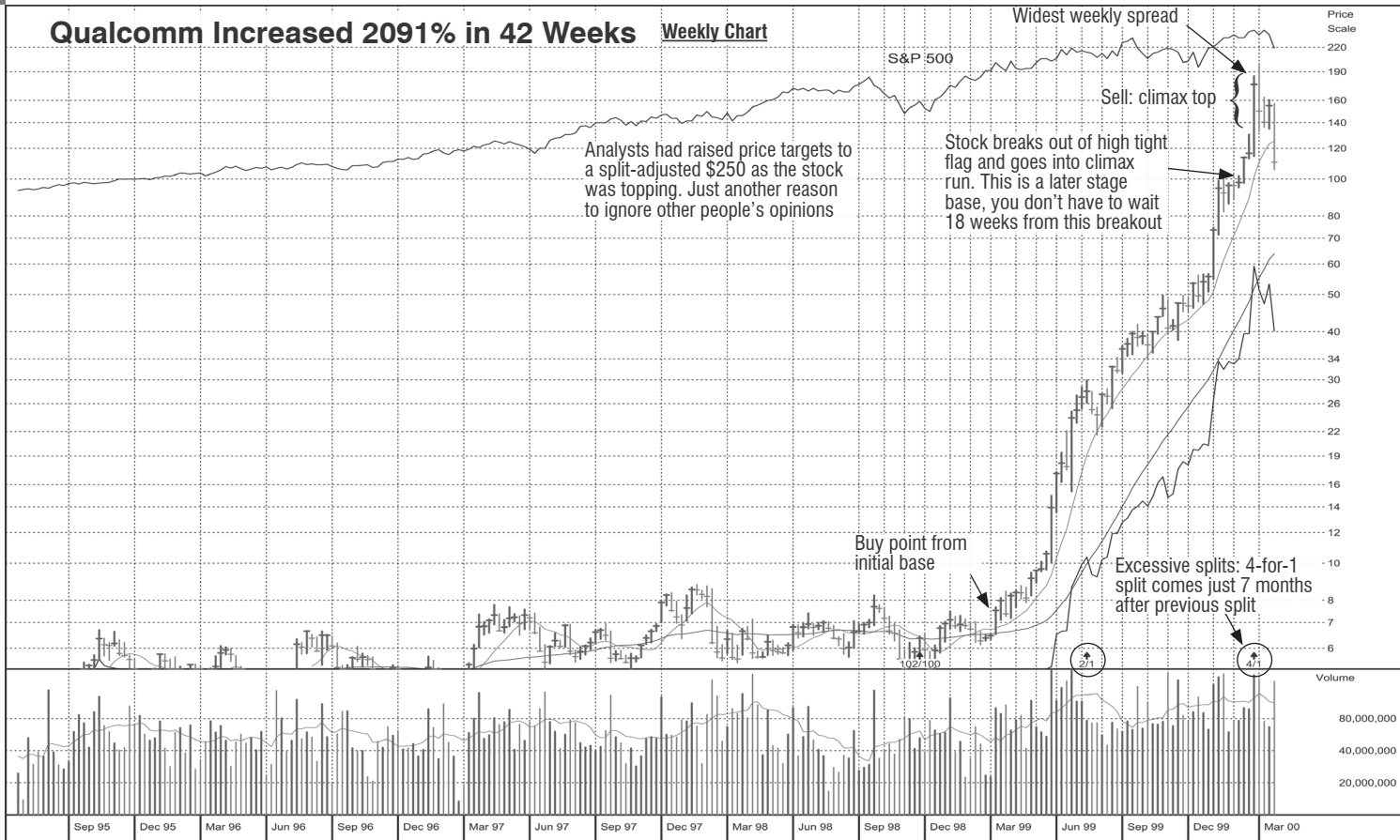
400,000

200,000

3 17 31 14 28 11 25 9 23 6 20 4 18 1 15 29 12 26 12 26 9 23 17 21 4 18
August September October November December January February March April May June

6/18/1999

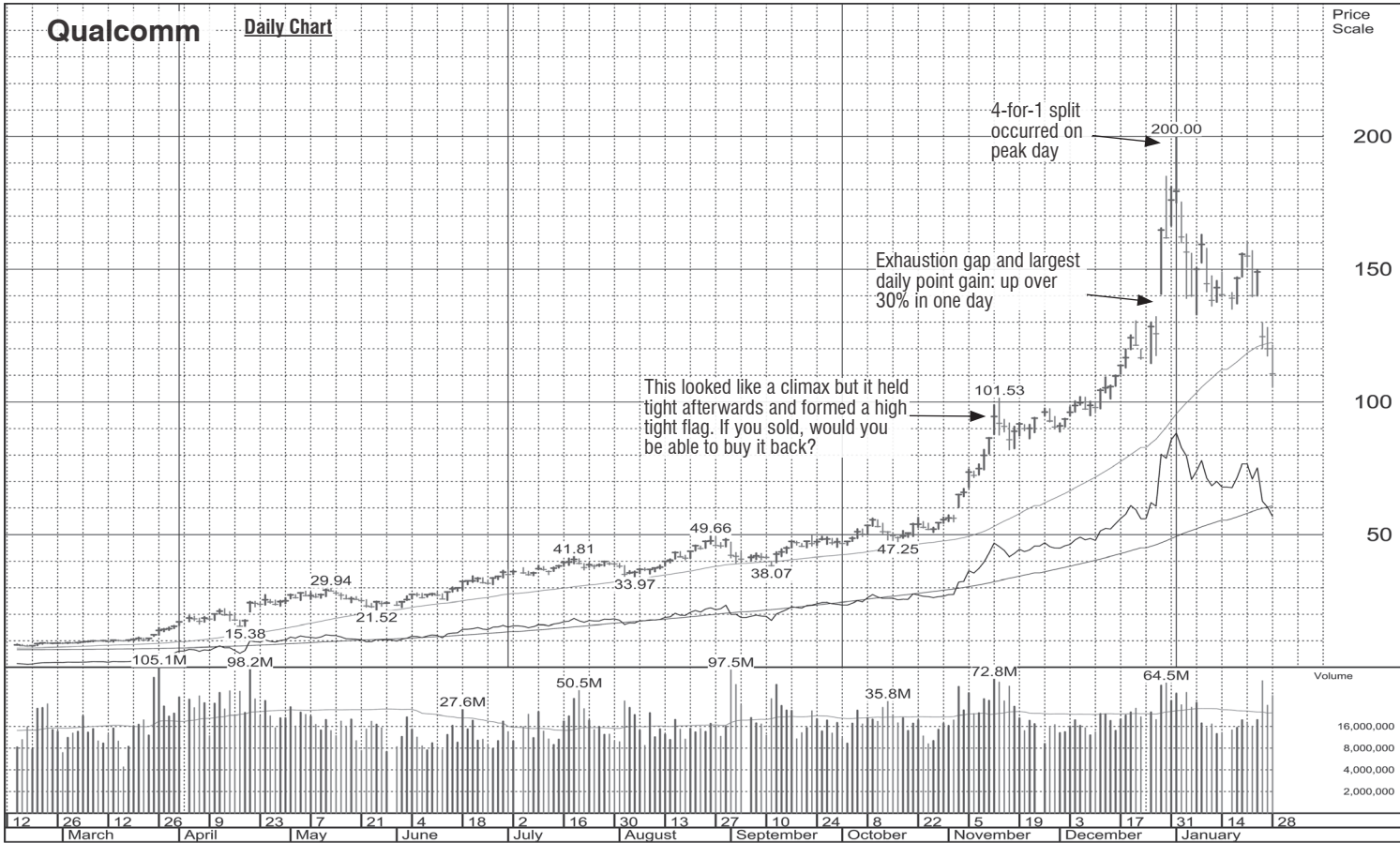
Qualcomm Increased 2091% in 42 Weeks Weekly Chart



1/28/2000

Qualcomm

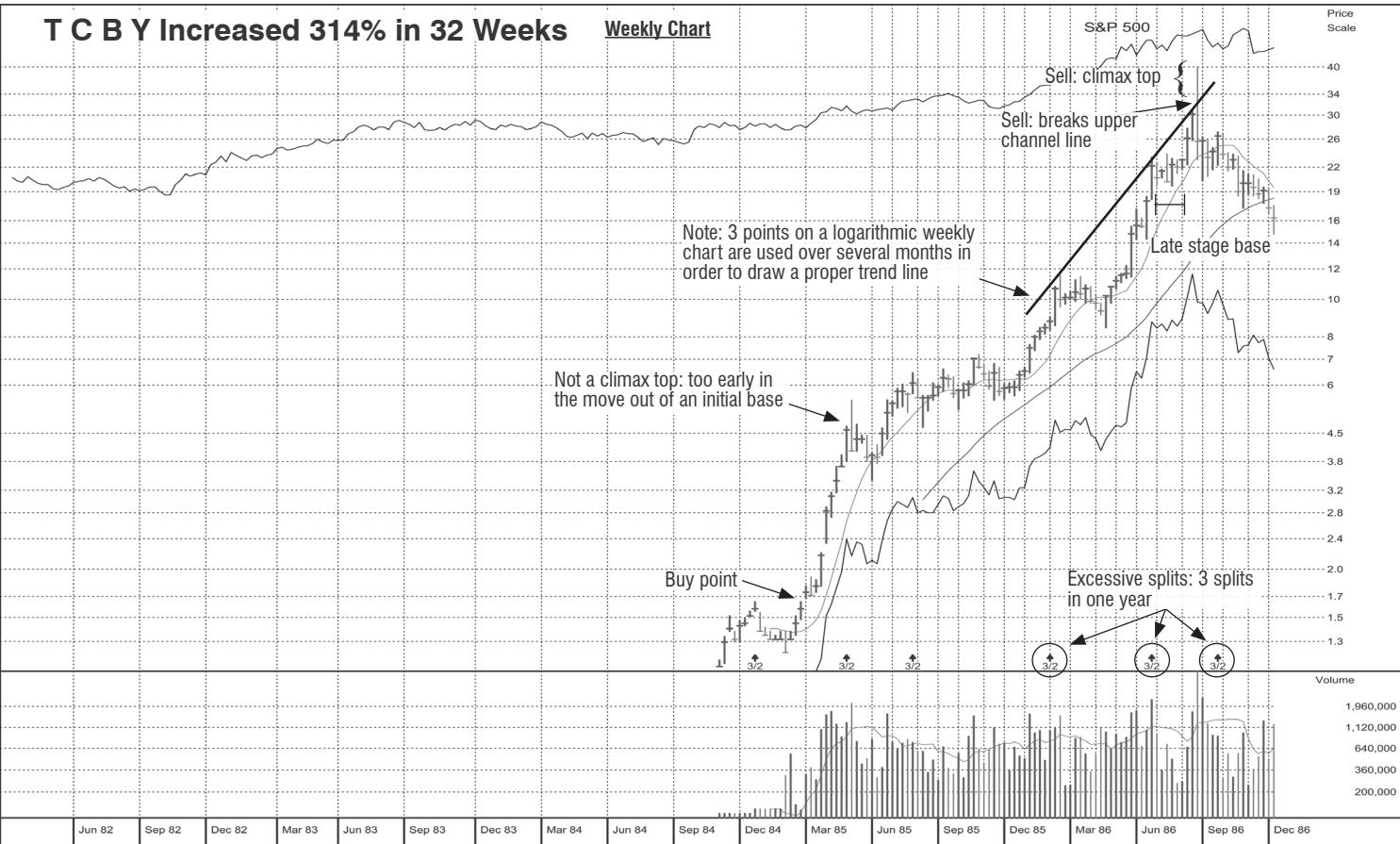
Daily Chart



1/28/2000

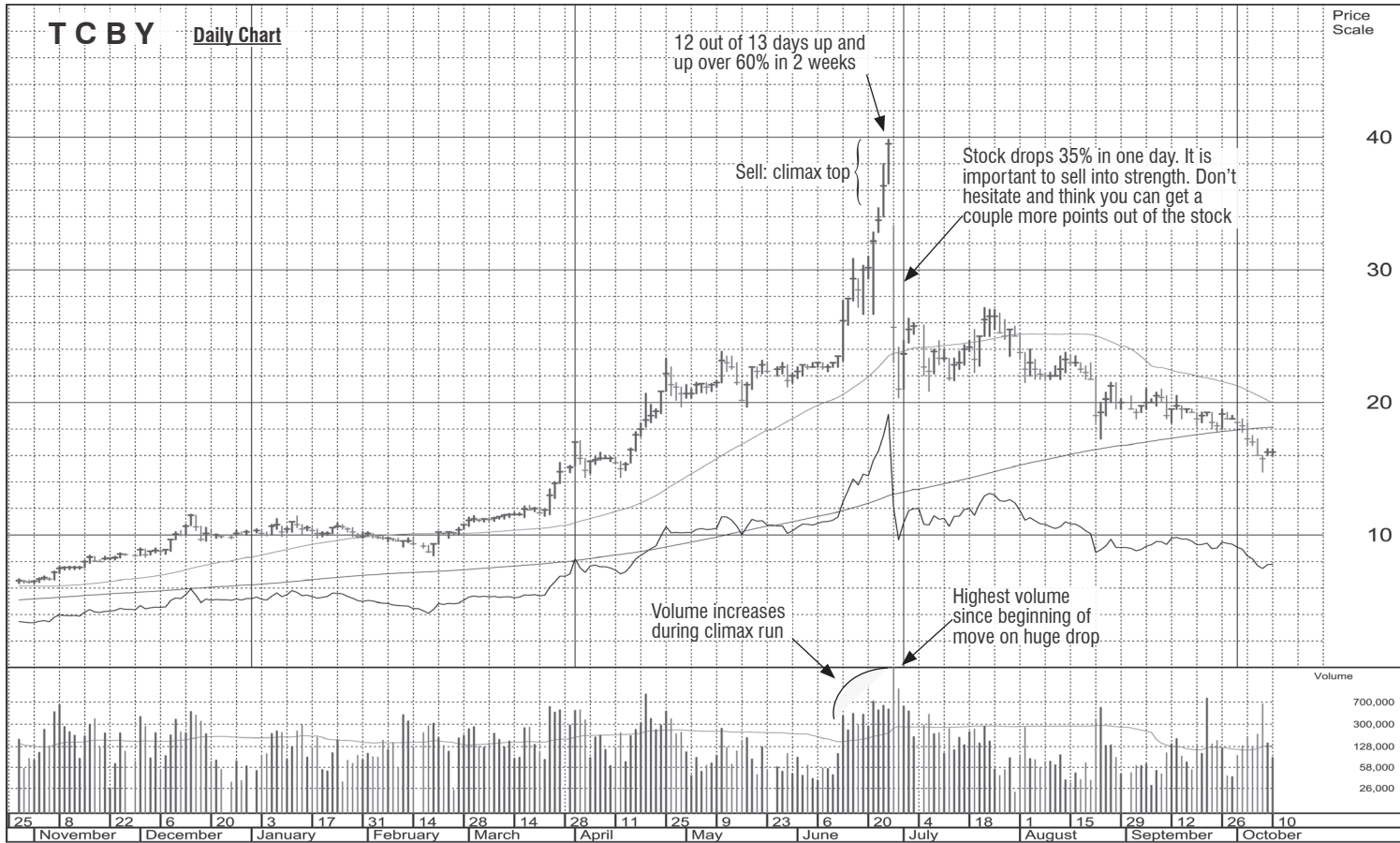
T C B Y Increased 314% in 32 Weeks

Weekly Chart



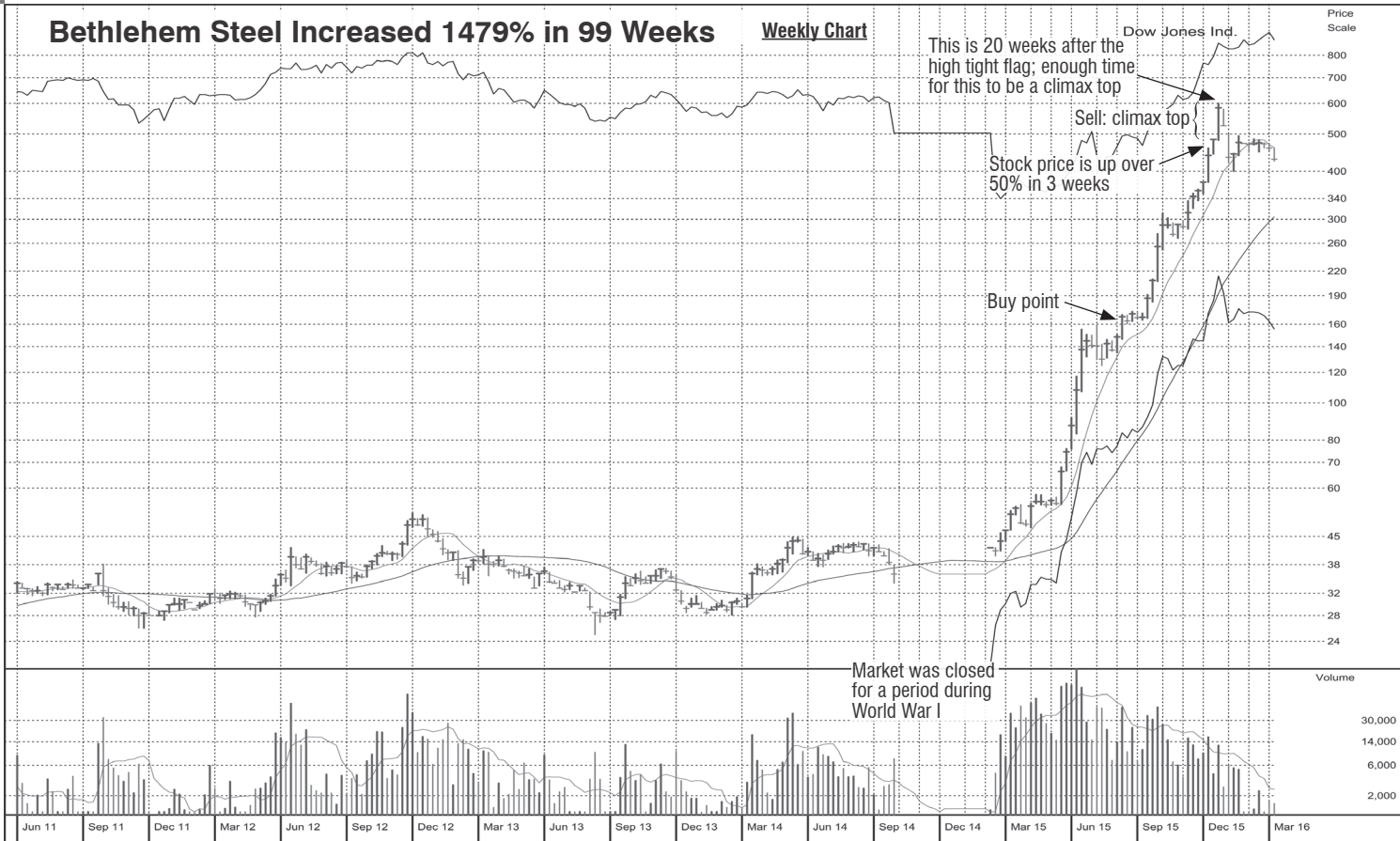
10/10/1986

TCBY Daily Chart



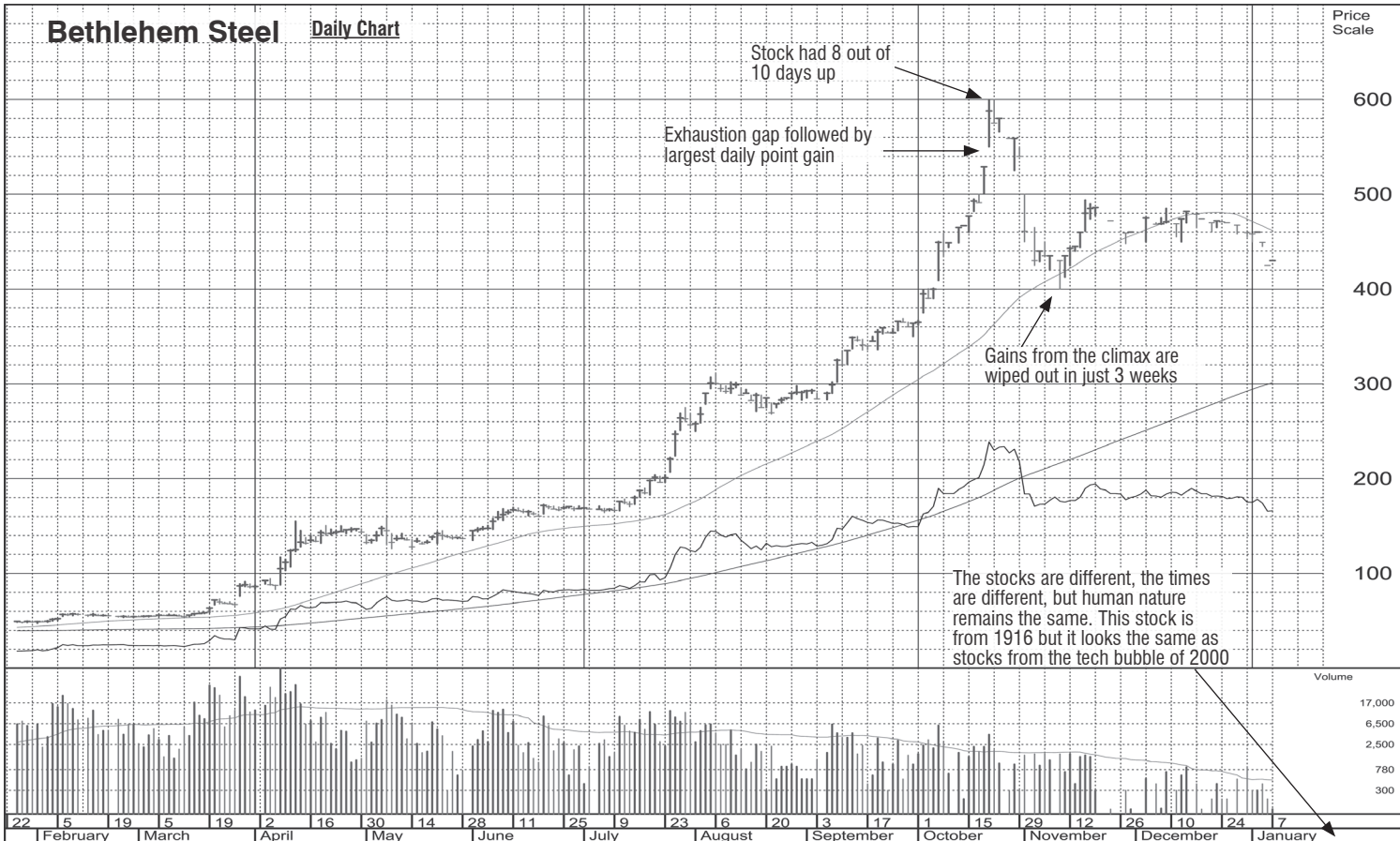
Bethlehem Steel Increased 1479% in 99 Weeks

Weekly Chart



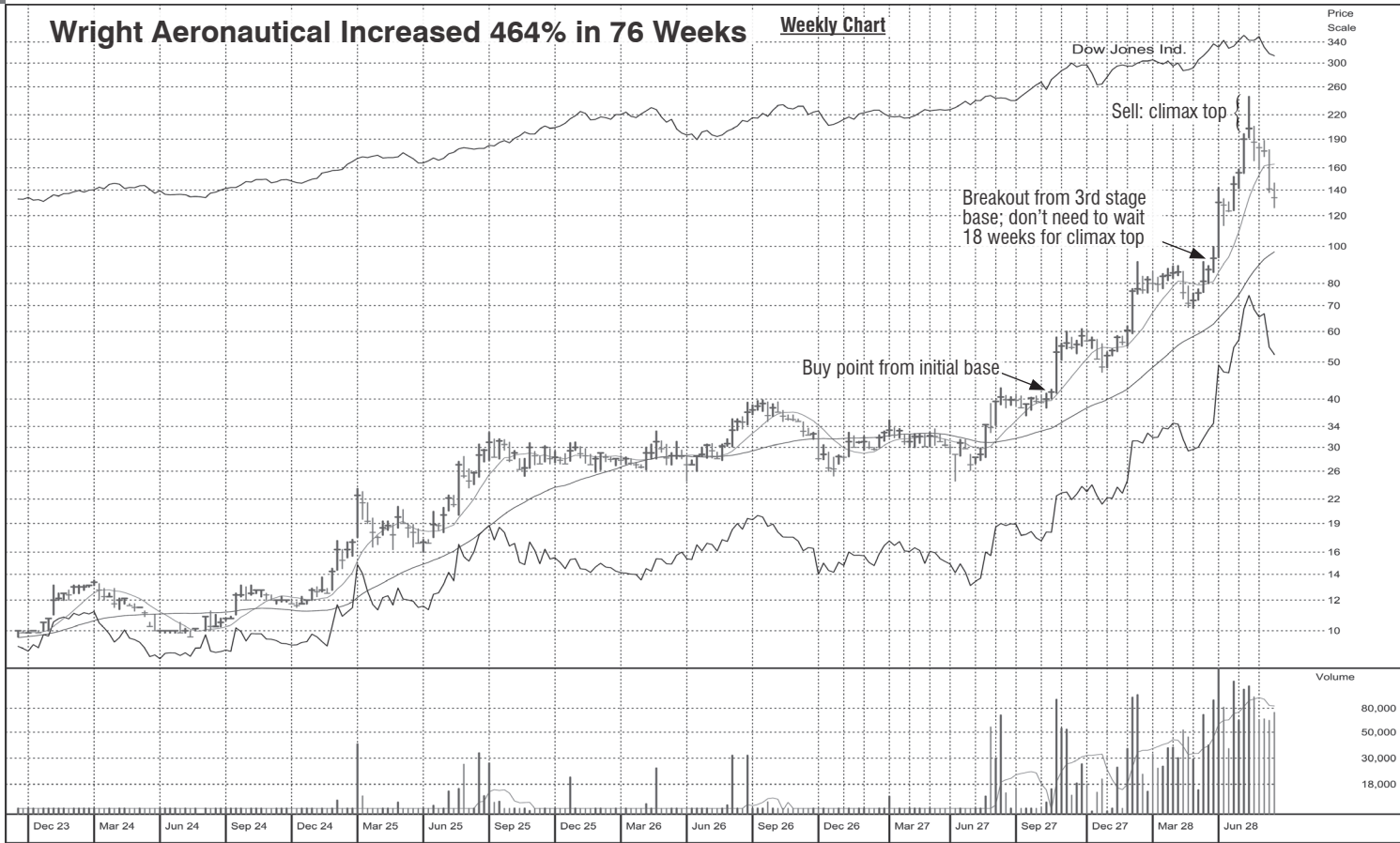
1/7/1916

Bethlehem Steel Daily Chart



Wright Aeronautical Increased 464% in 76 Weeks

Weekly Chart



Price Scale
340
300
260
220
190
160
140
120
100
80
70
60
50
40
34
30
26
19
16
14
12
10

Volume
80,000
50,000
30,000
18,000

Dow Jones Ind.

Sell: climax top

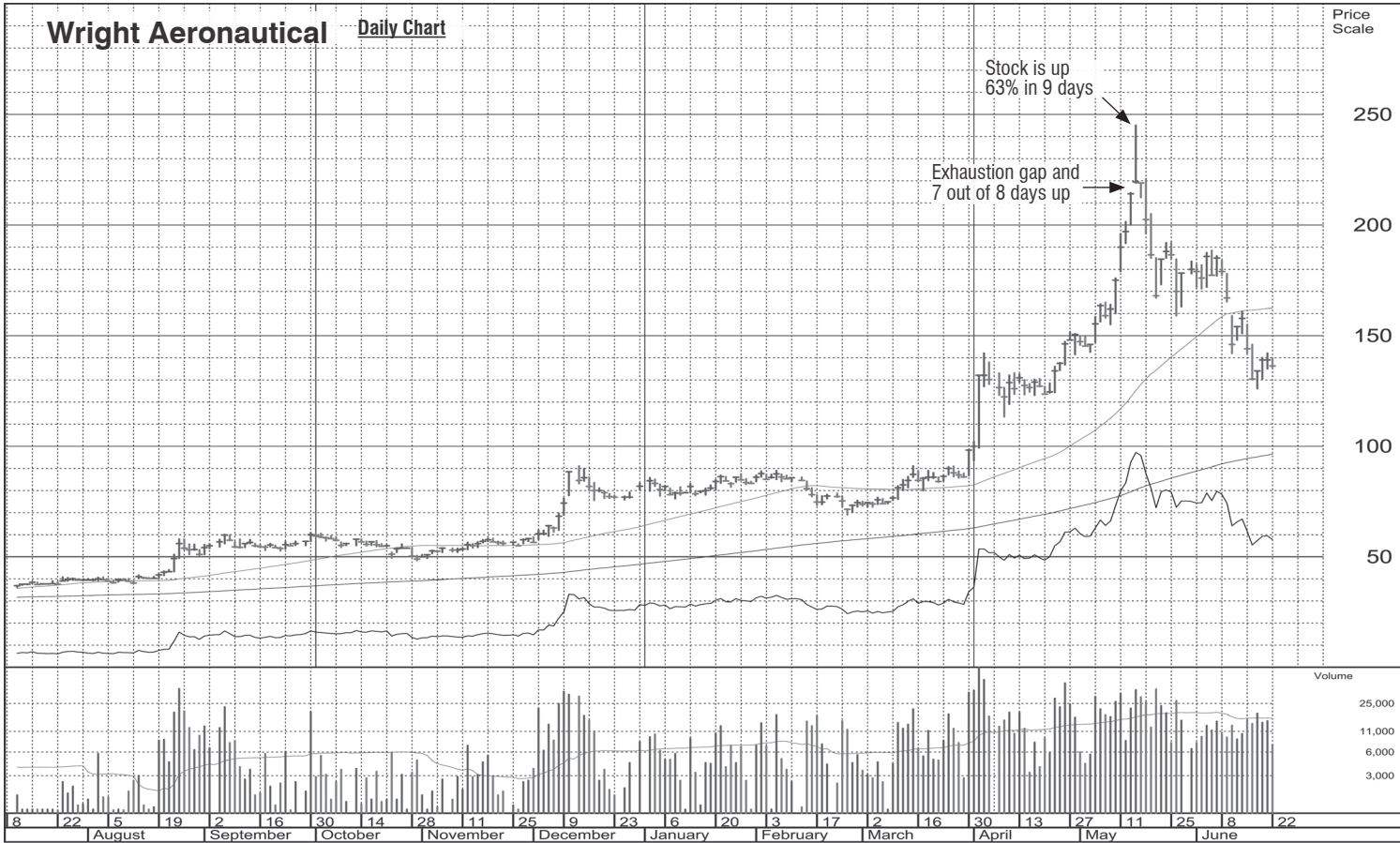
Breakout from 3rd stage base; don't need to wait 18 weeks for climax top

Buy point from initial base

Dec 23 Mar 24 Jun 24 Sep 24 Dec 24 Mar 25 Jun 25 Sep 25 Dec 25 Mar 26 Jun 26 Sep 26 Dec 26 Mar 27 Jun 27 Sep 27 Dec 27 Mar 28 Jun 28

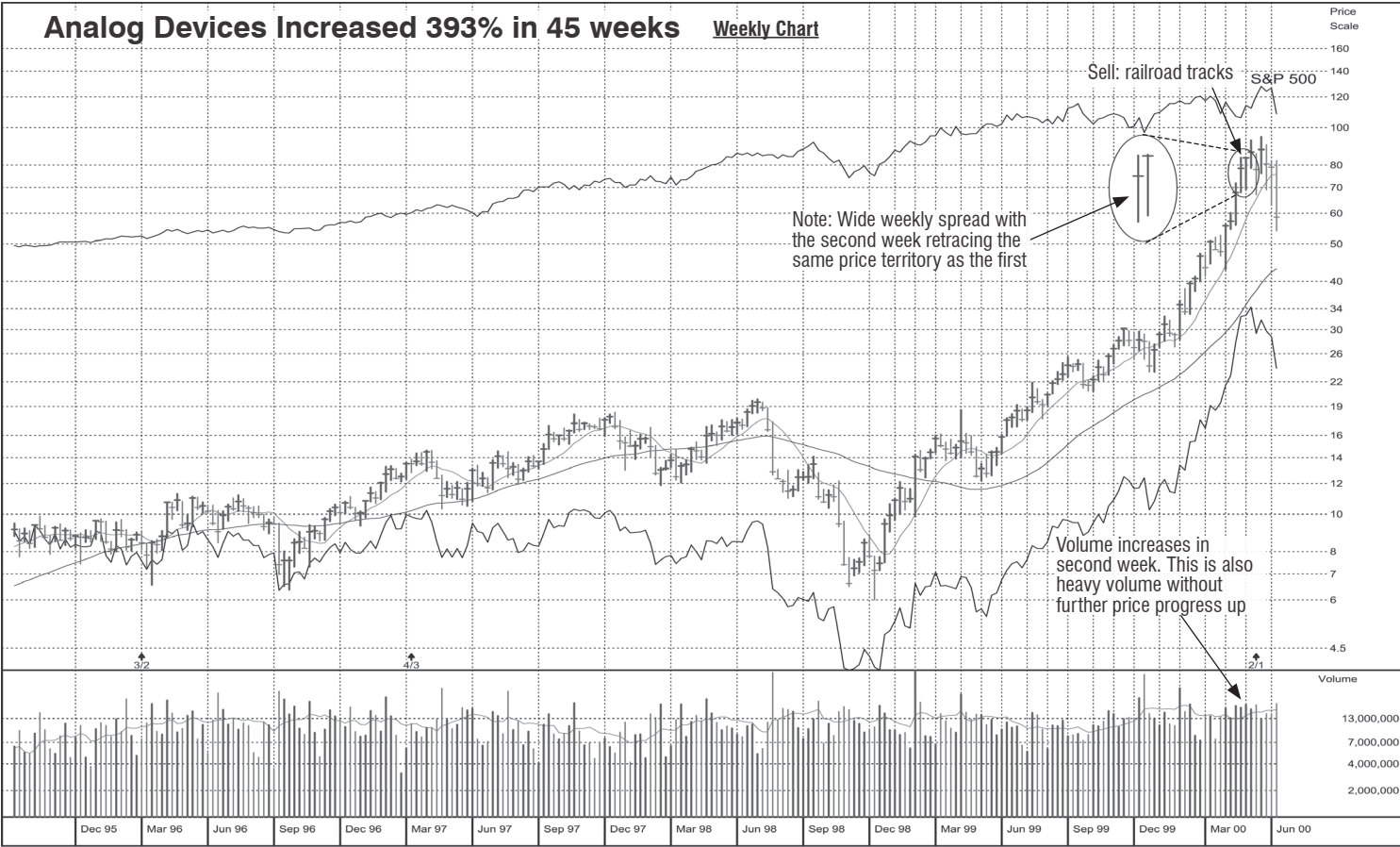
6/22/1928

Wright Aeronautical Daily Chart



6/22/1928

Analog Devices Increased 393% in 45 weeks Weekly Chart



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Sell Rules: **Climax Tops**

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