Market Dynamics

Volume 8, Issue I27

July 24, 2009

The Mystique Of Point And Figure

Performance Management System

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

Many investors have heard about point and figure charting but they know very little about it. The alternating columns of Xs and Os are mysterious to them. The fact that the chart is not plotted on a time scale is also confusing. There are very important reasons for the construction of the chart and the methodology incorporates several features that are extremely beneficial to an investor.

The three box reversal methodology requires that the price move in the opposite direction to the most recent trend by at least three boxes before a new column is plotted on the chart. This has the practical effect of removing minor fluctuations from the chart and allows the investor to focus on the major trends. This acts like a filter on the price data and much of the minor, random variation is removed.

The point and figure methodology plots movement up with an X and movement down with an O. Only the whole numbers are plotted. A trend is plotted in the current column of Xs or Os until a reversal is recorded. These alternating columns of Xs and Os represent intermediate trends in price. When a reversal occurs a new column is started in that direction. The alternating intermediate movements are plotted as columns of Xs and Os on the chart.

As new reversals take place the plot will move to the right on the chart. These movements are not a function of time but depend on the frequency of reversals. This means that the x-axis actually measures the number of trend reversals on the chart. The number of times the price trend reverses direction is a function of volatility. Volatility is usually considered a proxy for risk. Higher volatility indicates higher risk. A point and figure chart that shows lots of trend reversals is indicative of a high risk stock. Therefore the point and figure methodology is measuring risk along the x-axis.

The y-axis measures price. As the stock shows an up trend it will rise on the chart and move upward to the right as the intermediate term trends alternate back and forth. This alternating nature of stock prices is expressly incorporated into the point and figure chart. The major trend will be defined by the tops of the columns of Xs and the bottoms of the columns of Os. An up trend will be shown as a pattern of higher highs and higher lows. Conversely a downtrend will be shown as a pattern of lower lows and lower highs.

The Market Dynamics system converts the price data into relative performance ratios and those ratios are plotted on the chart. These charts emphasize relative price performance rather than just price. Most institutional investors are trying to do better than the market so a chart of relative performance is appropriate.

A 45-degree line is often drawn on the relative performance chart and it relates the number of reversals to the net progress of the stock. If the relative performance chart can remain above this 45-degree line it means that the stock has gained one unit of relative performance for each reversal of trend. This is a direct comparison of risk versus return and that is a key relationship for all investors. The true purpose of long-term point and figure charting is not to predict as much as it is to measure the performance of the stock relative to the market.

W. Clay Allen CFA

The long-term point and figure charts of relative performance reveal the relationship between risk and return for each stock.

A collection of recent newsletters is available on the web site.

Please visit the web site at http://www.clayallen.com/

Market Dynamics
7325 S. Jackson St.
Centennial, Colorado

Phone: 303-804-0507

clayallen@msn.com