

Using Bollinger Bands for Trading Large Cap Stocks

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Bollinger Bands are available on even the most rudimentary stock charting software. While not quite the holy grail, they do predict stock moves with greater accuracy than any indicator I have ever used.

Content:

The Bollinger Band is the closest thing to 'The Holy Grail' of technical analysis there is. Especially for large cap stock traders, it just cannot be beat for analyzing charts. Having said that however, there is probably no other technical indicator misused or misunderstood as often as the Bollinger Band (BB). This article is to provide the technical analyst with the basics needed to interpret the many faces of the BB.

Before we begin, let me explain the type of trading done at <http://livingonlargecaps.blogspot.com>. We trade large cap stocks, we generally hold stocks for less than two months, and make about 3-5% on an average trade. Done over and over again throughout the year, we have made over 50% annual returns for the last three years.

Now lets discuss what the Bollinger Band (BB) is. In its standard usage, the BB is derived from taking the 20 day moving average of the stock price. And then adding and subtracting two standard deviations of that stock price and placing a line above the moving average and below the moving average. Now without having to re-visit my statistics classes of some 25 years ago, I will try to clarify a standard deviation. It is simply a measurement of how far the price has deviated above or below the moving average. A stock going through a particularly volatile patch, will see its BB's expand, and a stock going through a calm period, will see them contract.

BB's are available on most charting software. Yahoo has them on their technical analysis charts, as do most other web sites that are dedicated to technical analysis. If you are unfamiliar with them I urge you to right now, go experiment with them, using a few stocks and market indicators like the Dow, or Nasdaq.

If you are familiar with technical analysis, and use indicators such as the RSI or stochastic. You know one of the unique things about the BB's is they are placed right on the stock charts. They are viewed in the context of the actual price movements. In fact, for me, they define the stock chart. Stock charts tell me way more about future movement with the BB placed on them. I rarely do any analysis without them, except for perhaps an initial viewing of a stock chart I am considering for watch list placement. BB's therefore do not give you a number, like most other indicators, they don't tell you an overbought or oversold condition. They just provide a visual, a story, of where a stock has been. Therefor you have to interpret.

But what can be learned is crucial, to guessing what will happen next. BB's can help you predict price movements, like no other tool. The trick is, to know what to look for. In other articles I will present what I require a price pattern to look like before I even consider it. But for this article, realize that price patterns need to be structured, calm, heading up, down or flat. But they can't be erratic. Erratic price patterns are never worth trading..

If the upper band and the lower band are not moving in unison then the pattern is erratic. There is one exception to this rule, and that is at the beginning of a powerful up or down move. Remember, the bands tell you where the price will fall in relative to the 20 day moving average. Well, if a powerful move is underway, then the price is moving away from the average, and the bands expand. Once the bands expand it is too late to trade that move, but the stock is worth watching, one can climb on board on the next pull back.

But trading the way we do on our blog ,at <http://livingonlargecaps.blogspot.com>, that has produced greater than 50% return three years running, we like the bands to move in unison. That shows predictability. And predictability is crucial in getting large returns. It is not the home run we are looking for, just hit after hit after hit. Load the bases repeatedly and you generate runs. OK enough baseball analogy. Here is an example, take the chart HIG. With BB's in place look at the chart in early June 2005. It is just after the powerful upward move, that occurred in May. First notice in May how the BBs expanded, as the stock shot straight up. Then in June the bands moved in unison. Around mid June the stock touched its 20 day moving average, then its formation started to 'bowl' as it moved up. Buy it here. Once it hits a 5% profit move up a sliding stop, and ride the price up. Several things can be learned form this chart. The single most bullish pattern, is a stock that has small trading day ranges, and hugs the upper band. It rides it up between the 20 day average, and the top band. The bands are at an upward angle, that is not too steep. And everything moves in unison, both bands, the moving average, and

most importantly for profits, the price.

If one should know anything about the stock market, it is this. It is ruled by emotions. Emotions are like springs, they stretch and contract, both for only so long. BB's measure this like no other indicator. A stock, especially widely traded large caps, with all the fundamental research in the world already done, will only lie dormant for so long, and then they will move. The move after such dormant periods will almost always be in the direction of the overall trend. If a stock is above it's 200 day moving average then it is in an uptrend, and the next move will likely be up as well.

Look at the chart CIT, with the BBs of course. See how in June 2005, the BB's contract late in the month. While the price touches the lower BB. See how the stock is above the 200 day moving average. And more importantly the slope of the 200 day moving average is upward. The stock clearly wants to move up. The bands are ridiculously close together. Buy right here, an oversold stock, moving upward, with narrow bands. What happens next is the bands expand, I call it fish lips, I love fish lips. This stock could have been bought in June sold at exhaustion as the bands had expanded with an upper band touch. And then re-purchased in July and done again. While fish lips provide remarkable entry signals, they generally aren't held as long as the upward unison movement of HIG mentioned above.

There you have the two most crucial lessons in Bollinger Bands. The HIG pattern I call riding the wave, and the CIT pattern I call fish lips. Riding the wave can usually be done longer up to two months, using stops along the way, one doesn't even really need to watch it, of course one can as they ca-ching in one those safe profits. The other pattern is fish lips, they are usually held for less than a month, and are exited upon upper band touches, or more exactly retreats from upper band touches. (When the price touches the upper band and then retreats). Fish lips that re formed out of a flat pattern can often turn into 'riding the wave,' and then are held longer.

CT Larsen has been trading stocks since 1990. Now trading large cap stocks exclusively. He has recorded three straight years of greater than 50% annual returns. You can read his blog at <http://livingonlargecaps.blogspot.com>.

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