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INTERVIEW

Take The Macro Road

Measuring Indicators With Fred Meissner

Fred Meissner, CMT, is the founder and president of The FRED Report. His professional career spans 33 years in the investment business, including serving as president of the Market Technicians Association from 2002 to 2004. His background encompasses market analysis, trading strategies/portfolio management, and business development/relationship management in diverse environments. He holds a BS degree in business administration (with a minor in economics) from Trinity University in San Antonio, TX, and an MA degree from The University of California, Los Angeles (UCLA) in Latin American studies with an interdisciplinary curriculum of international business, history, and sociology. Currently, Meissner publishes The FRED Report (www.thefredreport.com), offers a consulting service for financial advisors, and speaks extensively around the world on market analysis and the markets.

STOCKS & COMMODITIES Editor Jayanthi Gopalakrishnan spoke with Meissner on May 9, 2016 about how to effectively apply indicators in line with broad macro indicators.

I like to look at indicators on a discretionary basis and measure how they're doing. It's this measuring part that is vital and overlooked.

Fred, tell us a little bit about yourself and how you got interested in the markets.

I was in graduate school at UCLA. I had read some books about investing in the stock market before. I saw an ad in *The Daily Bruin* that asked the question, "Do you want to be a stockbroker?" The ad was by a small firm in Culver City, CA, and this company allowed you to work part-time and get your securities license. I thought it sounded interesting, so that's what I did. That's how I got started in this industry.

At that time, were you using fundamental analysis?

Yes, I was using fundamental analysis, and as I'm sure you've heard from lots of other people, I began to notice that sometimes, the fundamentals weren't working out as they should. When I finished my graduate studies, I went to work for Dean Witter Reynolds in Torrance, CA. There we had a lot more access to fundamental analysis, and I saw that it really didn't work most of the time. While I was looking for something that worked, I met a couple of advisors who used technical analysis, so I started studying it, and realized I had an affinity for it. And it turned into my career.

That's interesting.

I was a financial advisor—we called them "stockbrokers" back then—at Dean Witter and knew a guy named Jeff Weiss who at that time was the number two guy in the technical analysis department at Shearson Lehman. He got me over to Robinson Humphrey as a technician, and I ended up running the technical analysis department at Robinson Humphrey for many years under Bob Robbins, who was the chief investment strategist. Bob taught me how to relate technical signals to fundamentals, an important aspect of technical analysis that is often overlooked.

Robinson Humphrey was the largest regional brokerage firm in the country, but we were part of Shearson Lehman Brothers and then Smith Barney and then Citigroup.

What do you do now?

I quit Robinson Humphrey in 1999 and sold my Citigroup stock. I then went back into research in 2002 with a small firm that did institutional work on cycles. I then went to Merrill Lynch from 2004 to 2009 and now I'm writing independent research along similar lines to the research I wrote at Robinson Humphrey and Merrill Lynch.

I noticed that you publish your newsletters on a weekly and monthly basis, giving readers a broad perspective of the current markets. Why is it important for a technical trader to have a broad view of the markets before he or she starts to trade?

I've always done broad macro technical analysis. Most of my clients get in-depth fundamental research but I also believe that comprehensive macro trend analysis helps you understand where you are in the market, regardless of what you're trading. And that would help you judge your risk management.

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I'll give you an example.

A lot of technical traders use Bollinger Bands, which is a great indicator. I don't publish anything about Bollinger Bands but I do look at them. I think that if you're buying at the top end of a Bollinger Band, your risk management should be different than if you're buying at the bottom end. You have to have a broad perspective to know where you are in order to manage that risk.

Another thing about technical analysis I think people sometimes overlook is that good technical indicators do two things: They help you select a trade and tell you where you are in that trading process. But they also measure the progress of a trade that you're in. And that measurement can sometimes be more important than knowing that you've got a buy or sell signal. I can give you an example of that.

When I was trading for myself between 2000 and 2002, I embarked on a study of 30-minute bars on the S&P 500. I had been saving 30-minute S&P bars from the 1980s to the 2000s. So I had over 30,000 S&P bars to study.

Let's say I get a stochastic buy signal. What's the average amount of points gained before that indicator gives a sell signal? Let's say the average number of points on a buy signal is two. If you and I are sitting here trading and we get 12 points on a buy signal, what does that tell you about the market? It tells you the market is a lot stronger than average. It tells you that on the next buy signal, you can add or even double up on your trade because the market is stronger than average.

If you only get one point on the S&P, and the stochastic goes all the way up to 80 and turns over, you know that market is much weaker and you trade accordingly. That measuring factor can tell you much more. There're lots of indicators where that applies. This gives me a broad picture of the market instead of just looking at the indicator.

Most new traders look at an indicator and if the indicator gives a buy signal, they buy. They ignore the trend of the market and everything else.

I use a lot of different indicators, but the ones that I show and the ones I teach are a combination of stochastics and moving averages. If I'm using a daily chart to open a long trade and the weekly moving averages are positive, suggesting that the longer-term trend is up, I will be likely to stay with that trade a little longer than if the weekly moving averages are pointing straight down.

What I like about the stochastic is that it's essentially a moving average of trading ranges. And trading ranges are really important to me.

You can only do this if you have a big-picture view of things. Without that big-picture view you could have some astounding losses. Most brand-new traders don't do that well. I know that when I was a brand-new trader, I didn't do that well.

What did it take to change that and become what you are now?

It takes a lot of study and a lot of time. You can test trading systems using computers, but I think that people sometimes overlook just stepping back and looking at the indicator and what it does. Not many people look at an indicator and ask, "What phenomenon is that measuring?" I think that's really important to know.

One of the reasons I use stochastics in my analysis is because it generates more buy signals. A trader wants more than one signal a year. There may be people who want just one signal a year. If you don't look at what the indicator is trying to measure and how it does it, you may end up using the wrong indicator for your purposes.

Most of my clients don't buy and sell for technical reasons. They buy because a stock gets a fundamental upgrade. But if the stock gets a fundamental upgrade and the stochastic is at 20, that means a whole different thing than if the stochastic is at 90. When a stock gets that fundamental

upgrade and the stochastic is at 90, it pays to wait until it goes back to 20, which it will do. But there are traders who will often buy based on what they hear from another trader or friend. Well, how do you know where XYZ is unless you have a broad-perspective view? Buying Netflix at the absolute high in July just because you heard it's good is probably not as clever as waiting a bit.

So you consider yourself a discretionary trader?

Yes. I'm a great believer in discretionary trading systems versus mechanical trading systems. I have some good friends who use mechanical trading systems, but the type of client I work with can't really use a mechanical system. That's because different things are happening at different times. My clients are financial advisors who generally do not buy or sell for purely technical reasons. Often, they buy because a stock is upgraded to a buy fundamentally. Another reason could be that it is put on a recommended list or into a model portfolio. The same can happen in reverse—a stock can be downgraded fundamentally, or could be removed from a list. Or, in cases where the analyst leaves the firm, the advisor must sell. Of course, the advisor has some leeway as to when he must take action, and that's an area in which I often help clients.

Besides that, one problem I've always had with mechanical systems is that trading systems can't last forever. At some point they'll stop working and you'll have to use new ones. And when I ask someone how they know their system stopped working, they'll usually answer with something like high equity drawdown or adverse price excursion, which are just fancy ways of saying, " I

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lost a bunch of money on that." Now, the solution to that could be to have five or six different mechanical systems trading five or six different markets. That would mean you're diversified, which is fine, but because the people I work with are investing in balanced portfolios for their customers, I like to look at indicators on a discretionary basis and measure how they're doing. It's this measuring part that is vital and overlooked. And don't forget that you can use a mechanical system as an indicator—if the system says the trend is up, it can be great confirmation and vice versa.

By measuring, you mean what we discussed earlier.

What I use is the standard 14-period stochastic and the five- and 20-period moving averages. You can use different moving averages or different stochastic parameters. I'm going to use a funny analogy. The secret to being a good surfer is to know that waves come in sets, and your job as an optimal surfer is to catch the right wave in the set every single time. Say the market has been coming down, and the five- and 20-period moving averages are negative. So if I want to buy using the stochastic, then I want price to go up enough to have those moving averages go positive to confirm the buy. If they don't go positive after a while and price starts to act badly, you know that's a bad buy signal. I haven't figured out a good way to program that, especially because on a long-term basis, moving average systems generally don't work mechanically.

Why is that?

The reason is they give up too much of the profits you already have, or they don't get you in soon enough after they decline. I'll give you an example. In March 2009, we got a great signal on the stochastics to buy the S&P. The moving averages were negative and did not confirm that trend until the S&P went from roughly 670 to 1,070.

When you get that trending buy signal, all you know at the time is that it went up 400 points or almost doubled. But before you got your trending buy signal, you did not know that it was going to go up an additional 1,400 points from there, which it did do.

Well, those moving averages went negative in December 2015. So if you use that trend-following system, you went long in June/July of 2009 and got out in December 2015. You were still not back in. The market went from 1,800 to 2,000 and you're still not in. And if you look at the moving averages, they got more negative in the following month. It's going to take even more to get you in.

This is why no algorithm can be used for moving average systems. But if you look at it and tell yourself that you should be a little more cautious while these are negative and you just had a great run, that's helpful information.

Can you give another example of measuring moves?

If you look at the stock of Apple Inc. (AAPL), you'll see that the stock goes through 50% retracements often. Say the stock moves down from 720 to 340 and you realize that all it did was a 50% retracement before starting its next up move, that information can be helpful. Say the stock went from a low around 56 to a high closing price of around 130. You take 56 and add it to 130 and you get 186. Divide that by 2 and you get 93. Where did the stock bottom? It's at $93.52 right now, which is close enough. If you know that AAPL has done this type of retracement several times and you see that the monthly stochastic is at 16 and getting ready to turn up, even if everybody on TV is saying the company's never going to earn any money ever, you see that the stock is at your buy point, which you knew about in advance. It might be worth adding to your portfolio for the dividend. When you get a monthly buy signal on AAPL and you're $2.00 from that retracement point, you might want to think about buying some AAPL stock. That's another reason to say you want to look at the big macro picture. There are stocks that never do 50% retracements and for those stocks there's no point in placing Fibonacci levels on your chart because you'll be waiting a long time for a 50% retracement.

When there are so many indicators, why did you create your own indicators?

I looked at some of the other indicators out there and discovered that they were lagging. There were some things they didn't have that I wanted to have.

For example, I work a lot with people who work with Dorsey-Wright, who does a great job of relative strength analysis. But I have some issues with point & figure charting. The biggest issue is it uses only closing prices. If I have a trading vehicle that goes from, say, $1 to $3, then to 1, then to 3, then to 1, from 1 to 10, but closes at 3, and then goes to 1, and then to 3, the most important bar to me is the one that goes from 1 to 10. Point & figure charting ignores that completely. It's like that never happened.

What I like about the stochastic is that it's essentially a moving average of trading ranges. And trading ranges are really important to me. So some of the indicators I've built take into account the entire range. There's nothing out there that does that except for stochastics. So I had to build my own.

And the same goes for your breadth oscillator?

I have a breadth oscillator that essentially works with breadth similarly to the way the McClellan oscillator does. I love the McClellan oscillator and often reflect on how wonderful Sherman McClellan was to invent it. The issue I have with the McClellan oscillator is that it's very quick. I wanted to slow breadth down, so I had to build my own breadth oscillator.

What timeframe charts do you use?

I use daily and weekly charts, and on occasion, even monthly charts. When you think about the 50- and 200-day moving averages—and this may sound

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Good technical indicators do two things: They help you select a trade and tell you where you are in that trading process. They also measure the progress of an open trade.

funny to you—one of the reasons those were used was because they were very easy to calculate on a hand calculator. That's why Granville invented them that way. If you divide 200 by 4, you get 50. It's really easy to do. And now we have computers so you don't have to do any of those calculations. If I want my five- and 20-day to expand in time, all I have to do is switch to a weekly or monthly chart and see them displayed.

One of the reasons I use the five and 20 periods is that the average quoting machine has the 50 and 200 as defaults and it's easy for people to remember to take off just one zero and then save the chart. Really, that's why I do it. It's easy for people to remember to just take off a zero.

We are in the midst of an election year in the US. How do elections impact the financial markets?

We saw the markets start to narrow in July/August 2015. That narrowing up—that is, the falling off of small- and mid-caps, and the money flowing into large-cap stocks—is much more important to me than who's going to be president from the standpoint of the market.

There are a lot of mutual funds out there that have to be 80% invested in stocks. When those big guys—who get great information that we don't get—start to see a bear or tough market coming, their tendency is to sell their junk and buy quality, and that's reflected in the new high/new low indicators. Those were negative for much of 2015 and the first part of 2016, and that reflects that narrowing.

In the last month, we've seen that situation start to reverse. The Russell 2000 was up a bit more than the S&P 500. As far as the election, what I've observed and learned from various senior investment strategists is that after six months, no one is going to care. You could say for the first couple of months or three months, no one likes uncertainty. And so people may be a little bit more skittish. But I'll look at market internals.

Last year, when I saw the amount of new lows, negative week after week, I knew the big guys were selling. That's the best footprint you can look at to see what they are doing. And that's why we were cautious for the last part of the year and into the first part of this year.

Now that has switched and it looks like the market is saying that whoever is elected probably isn't going to be so bad. I think there will be three of four months where the markets might be erratic, but after that, it's going to be as if the election never happened.

That's what I thought. Thank you for speaking with us, Fred.

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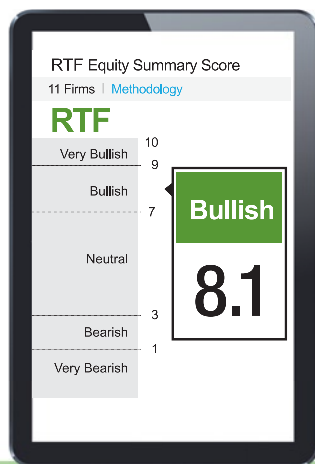

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