

Three Rules and Three Tools to Spot Oversold Stocks

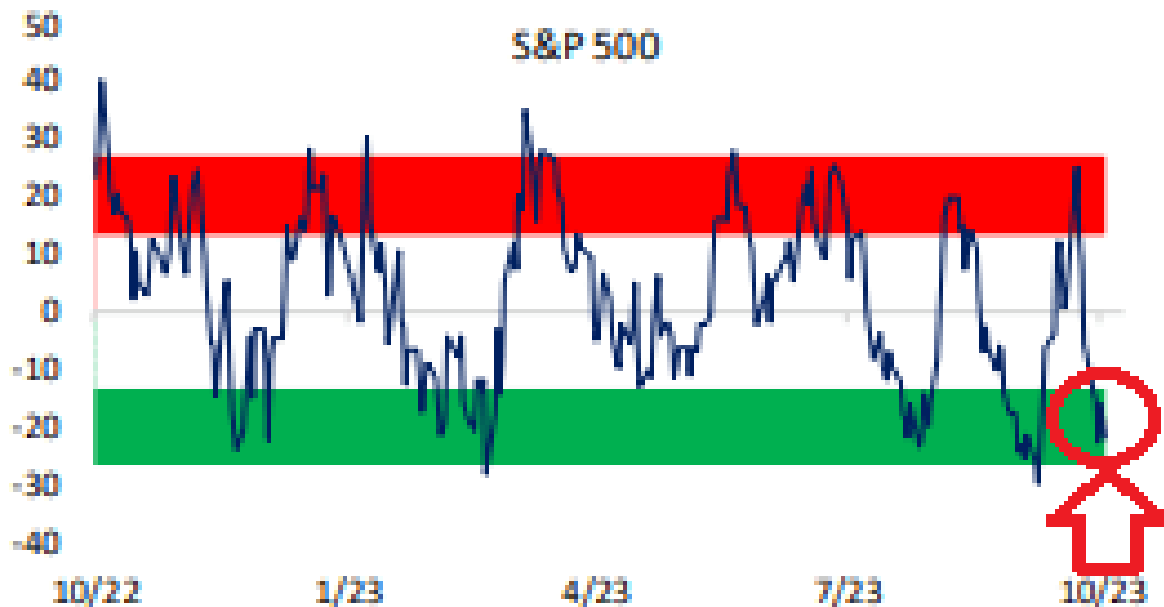
I'm sure you've heard the Warren Buffett quote that you should "be fearful when others are greedy and be greedy only when others are fearful."

Aside from "buy low, sell high" it's probably among the most-often repeated pieces of investment wisdom out there.

What is maybe less obvious is how to pinpoint those turning points and what – specifically – to do once you've identified them.

The good folks at Bespoke Investment Group publish an indicator that I like to use as one proof point for identifying whether we're in a greedy or fearful market stage. And, spoiler alert: Today we're sitting squarely in a fearful phase.

In fact, the stock market looks *deeply* oversold right now.



www.bespokepremium.com

The chart above shows the 10-day average of advancing versus declining (or A-D) stocks for the market overall. As you can see, the S&P 500 Index and its current A-D reading are oversold.

What's striking is that Bespoke also tracks each of the 11 stock market sectors. And right now, all but two of the 11 sectors are also *deeply* oversold. In fact, the only exceptions to the oversold picture are utility stocks, which are neutral, and consumer staples, which are overbought.

That's the hallmark of a fearful stock market: When investors flock to the relative safety of defensive stocks including utilities and staples.

So today, I'm going to show you how to follow the second half of Buffett's mantra. I'll show you how to find potential buying opportunities in the deeply oversold sectors – where investors are exhibiting the most fear.

Three Rules and Three Tools

There are three rules of thumb that I live by when it comes to prospecting for oversold stocks. And you should strongly consider them, too.

1. Look for an upside catalyst.
2. Buy at strong support.
3. Look for relative strength.

But I wouldn't be doing my job if I just told you what to look for without telling you how.

In fact – lucky us – there are three handy tools already within *TradeSmith Finance* that match up perfectly and can help you when prospecting for oversold stocks. They are:

1. Our proprietary **Trade Cycles Peak and Valley Indicators**
2. The **Volume-At-Price Indicator (VAP)**
3. **The Relative Strength Index (RSI)**

Let's take a closer look at these three tools and how to use them.

The very first step is to find a list of healthy, high-quality stocks that have an upside catalyst. If there is a third piece of investing wisdom that I would add to the two I mentioned earlier, it would be this: Don't buy stock in crappy companies.

Once you've got your list of strong companies, then apply rules 2 and 3.

Let's dig in and see how this works in action.

Screening for Fear

As I often do, I'll use our *TradeSmith* Screener tool to get started. Note that you'll need access to the Screener via *Ideas by TradeSmith*, *Trade360*, *TradeSmith Essentials*, or a Platinum membership, and our Business Quality Score (BQS) tool via *Ratings by TradeSmith* or Platinum.

Be sure you are logged in to *TradeSmith Finance*. Click **Invest** on the top menu, then the **Screener** tab. Click the "+ Create New Screener" button and set up the following:

TRADESMITH FINANCE Dashboard My Portfolios Markets Invest Options My Gurus Calendar Pubs Baskets

← BACK

+ Manage Filters

Health Status **1.** ▶ Green Zone ● Yellow Zone ■ Red Zone

Trend ✓ Up □ Down ✓ Sideways

Markets **2.** ✕ S&P 500 (SPX) ✕ Nasdaq 100 (NDX) +

Cycle Turn Area ✕ Upcoming Valley ✕ Valley ✕

Cycle Period **3.** ✕ Composite Cycle ✕

Cycle Conviction Level ✕ High ✕ Medium ✕ Very High ✕

Business Quality Score **4.** more than 75

Display & Sort Results Show top 250 Sort results by Health DESC

1. I want healthy stocks that can trend higher, so I included filters for **Health Status** Green Zone and **Trend** Up or Sideways.

2. Since the entire market looks oversold here including most sectors, I filtered **Markets** by S&P 500 Index (SPX) and Nasdaq 100 Index (NDX).

Next comes our proprietary **Trade Cycles** timing indicators that can really give you an edge by zeroing in on stocks poised to move higher.

3. Under **Cycle Turn Area**, I'm looking for stocks in a Valley or an Upcoming Valley, based on the Composite **Cycle Period** (an average of all our timing cycles), and a **Cycle Conviction Level** of Medium, High, or Very High.

4. As always, I want to prospect in high-quality stocks to help avoid value traps. I use our proprietary **Business Quality Score (BQS)** and set it to more than 75, to narrow my list to only the top 25% of stocks by BQS.

Finally, I **Display & Sort Results** by Health.

This “fear” screener gave me 51 stocks that met all my filters. That’s a good field to prospect in with further research. But you can always tighten or loosen some of these filters, or add your own, to either narrow or expand your list.

Now let’s also apply rules 2 and 3.

I mentioned two additional tools to help us here:

- **Volume at Price (VAP):** to find stocks that should be trading at solid support levels, and
- **Relative Strength Index (RSI):** to find potentially oversold stocks with upside momentum.

Let’s look at how each indicator works, and then I’ll illustrate with an example.

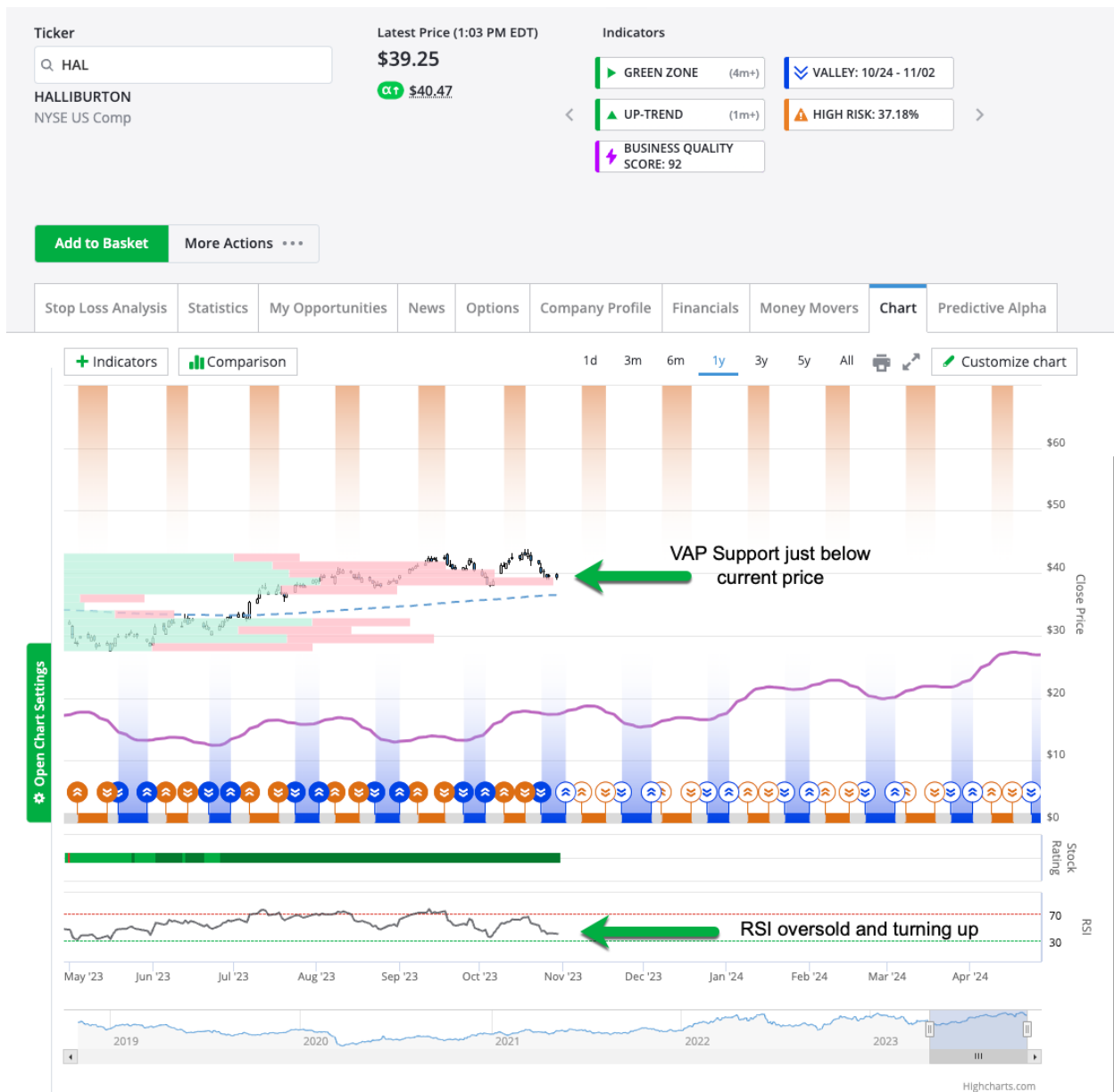
VAP shows you the amount of volume for a particular price range. On *TradeSmith Finance* charts, it’s displayed as horizontal bars on the left side of the chart to correspond with price ranges. By combining volume and prices, this indicator can help you identify high-volume price ranges to mark support or resistance levels for the stock.

Developed by J. Welles Wilder, RSI measures the speed and change of price movements over time (usually a 14-day period). The RSI oscillates between zero and 100. When the RSI is above 70, it generally indicates overbought conditions. And when the RSI is below 30, it indicates oversold conditions.

To find possible oversold buying opportunities, I look for a stock with low RSI, generally below 40 or 50. Ideally, the RSI was recently below 30 and is already rebounding, indicating the stock itself is in an upward trend. And by studying the VAP bars, you can easily see if the stock is trading at a good support level and whether it’s poised to move higher, according to our *Trade Cycles*.

Case Study on a High-Quality Stock with Upside Catalyst

Here’s an example using one of the stocks that made the cut on my screener. It’s energy services giant Haliburton (HAL).



This stock has pulled back in price recently along with the market. Yet it's a solid company with a Strong Bullish rating from *TradeSmith* and a BQS of 92, in the top 8% of all stocks we rank by quality.

Plus, HAL just entered a valley turn area on Oct. 24, meaning the stock should turn higher from here. And you can see from the dotted blue line that *TradeSmith's* smart moving average bears that out – the stock is in a fairly recent uptrend.

In other words: It's a strong company with an upside catalyst, according to our system.

We've checked the first rule off the list for HAL; now let's look at our two additional rules and indicators.

Volume at Price: On the chart above, did you notice that big horizontal bar just below the current price? It shows there is a strong price at the volume level stretching from roughly \$37 up to \$40. That means

significant buying has taken place at this price level previously, so it should provide important support here to HAL's price.

Relative Strength Index: HAL was pretty oversold this month, hitting a low of 35 in early October. Since then, the stock has gone mostly sideways in a trading range. Meanwhile, the RSI has improved. It's now up to just above 41, and that's a positive divergence indicating HAL is gaining relative price strength.

Mike Burnick's Bottom Line: You can use our powerful *TradeSmith* Screener tools to find a select list of stocks meeting your favorite filters. That's a great starting point for more research. And there's no substitute for taking a closer look at the individual charts of the stocks on your list. Pay close attention to price trends and our *Trade Cycles* forecasts. Use VAP and RSI to help confirm a stock is a buy candidate.

Put them all together and pull gains out of market fear, just like Buffett.

Good investing,

Mike Burnick

Senior Analyst, *TradeSmith*

P.S. If you have any questions or concerns, please reach out to me at emailmikeburnick@tradesmith.com and include "Inside TradeSmith" in the subject line.