

Divergence Analysis

This document was written in October, 2009 by Pascal Willain as part of a training program on the use of the Effective Volume tools.

The author can be contacted at: pascal@willain.com
Daily and weekly market updates are available on www.effectivevolume.eu

The author is French speaking.
This report has not been proof-read for the proper use of English language.

A divergence forms when LEV trend is opposite to the price trend for at least three days.

Positive and negative divergences can be found in the links below:

<http://www.effectivevolume.eu/content/Filters/Posdiv.php>

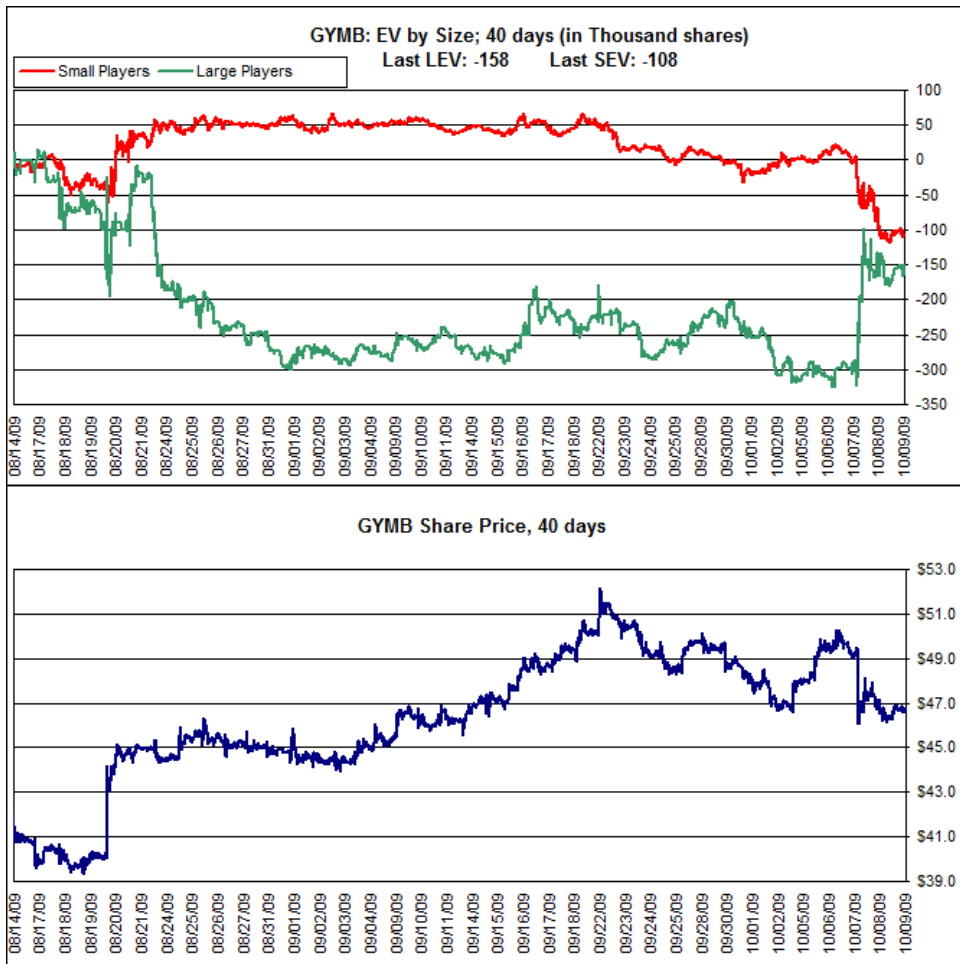
<http://www.effectivevolume.eu/content/Filters/Negdiv.php>

My back-test has shown that buying positive divergence stocks and shorting negative divergence stocks has no positive correlation to the trading profits. The reason for this strange conclusion is that using EV without any reference to a "value" zone is like comparing apples and oranges. Indeed, EV could be trending up either because buyers are coming or short sellers are covering. There is no way to know for sure.

Furthermore, during earnings season, shareholders would swiftly act upon earnings, which could send EV straight up or straight down: shareholders are playing their portfolio, they are adjusting it to the new perceived value. After a big news such as earnings, EV needs time to adjust.

Let's take some examples that are in the first link above, as of Oct 11. I copy the figures below, because the links are daily adjusted.

First, let's look at apparel maker GYMB below: The company had its earnings on October 7. They did "ok" and bargain hunters jumped on the news. However, revenues were guided down and the euphoria receded.



If I was interested in this stock, I would wait some days and see if the stock can hold its 50MA and if the support zone attracts money. However, the sharp drop on huge volume does not bode well.



The two links below are more interesting, because they show EV, TEV and the AB patterns.

Positive divergence stocks are shows here with their AB indicator

http://www.effectivevolume.eu/content/Filters/Posdiv_rating.php

Negative divergence stocks are shows here with their AB indicator

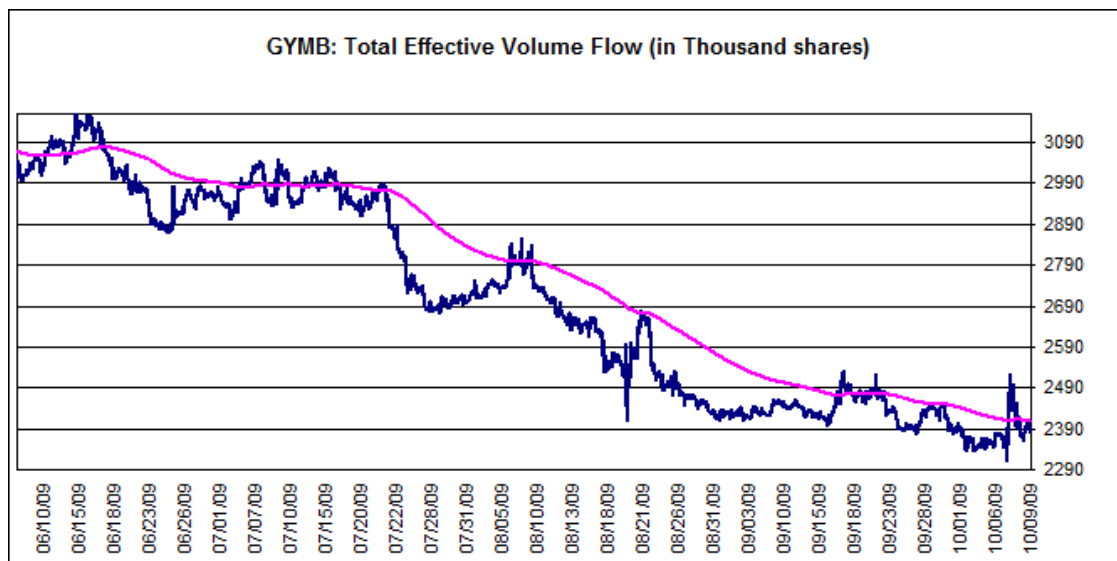
http://www.effectivevolume.eu/content/Filters/Negdiv_rating.php

Working with these links is like fishing with a big net: you get all sorts of fish and you need time to sort through them.

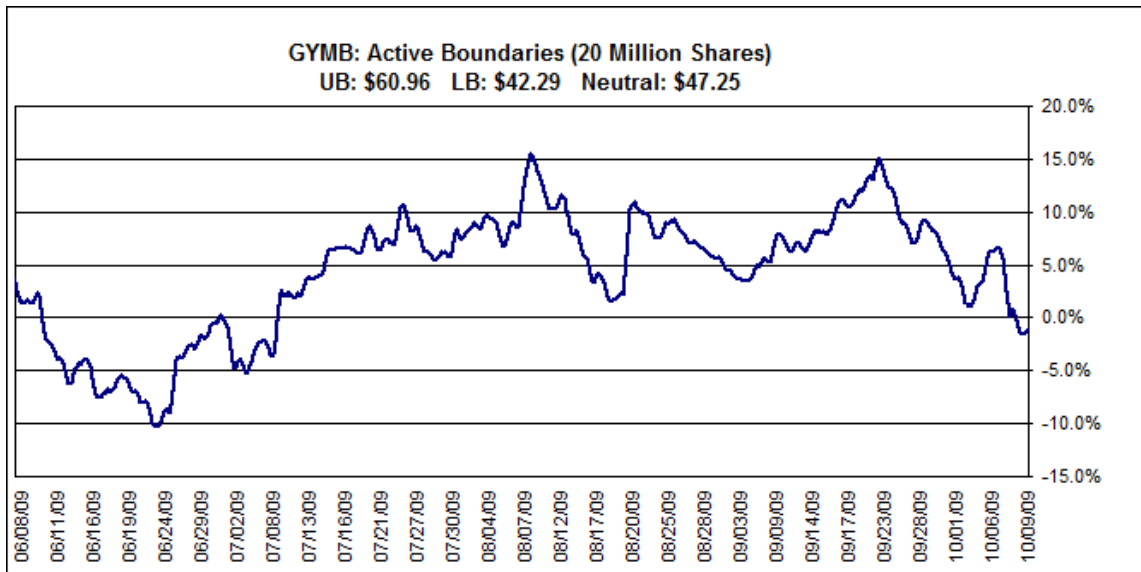
This however alerts you on special situations that may be developing (see UUA for example).

In the case of GYMB, We see that TEV has been trending down all the way during the up-trend, an indication that shareholders were taking profits. This means that the stocks has been pulled-up by its sector, but that it had to work its way up through much resistance. In September, we reached a 52-weeks high, and selling stopped, because resistance disappeared. However, new buyers are not coming in and the stock started to "drift down" on low volume.

This is the reason why it is safer to buy leading stocks that are making a new high, because there is no resistance above. Therefore, a leading stock would not find it hard to continue climbing up.



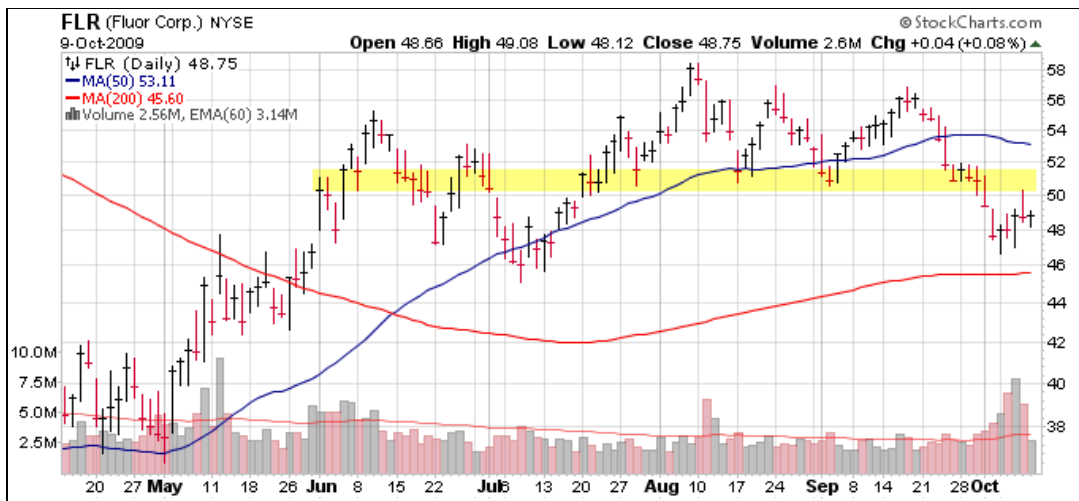
The AB figure below shows that GYMB is close to value (0%). This is where you would buy on increasing EV - which is far from being the case here.



Let's now look at a possible short situation: the construction company FLR (Picked up from the link of negative divergences with AB)

The standard TA shows a company that broke through its 50MA but reversed back from the \$47 Support. The EV pattern shows a very sick company that is shortable on its reversal back to resistance.

The AB figure indeed shows that a reversal to the neutral zone (\$51.98) is the ideal position to enter new short.



The figure below, taken on November 9 shows that the neutral position close to \$52 was a good short location.

