THE GMMA – JOINING ESTABLISHED TRENDS

By Daryl Guppy

Many new readers have asked about the GMMA, how it is constructed and how it is used for trading. I developed the GMMA in 1994 and have used and refined its application over the past 20 years. It is a robust and reliable analysis indicator widely used in equity, currency and commodity markets. The GMMA can be applied in any time frame – daily charts, 1 minute charts, 1 hour charts etc. It tracks the psychological behavior of market participants. In FX markets, we use a Super Guppy to track the volatility clustering and identify trend change points. We include these notes for new readers. ED.

Last week we considered the logic behind the construction of the Guppy Multiple Moving Average indicator (GMMA) and the way it is used to understand the activity of traders and investors. The initial application of this indicator is designed to confirm that a new up trend has developed after the initial signal generated by a close above a straight edge trend line. Many traders spend a lot of time looking for these breakout situations because the rewards for success are great. However a breakout also caries a higher level of risk because the chance of failure is often high. The focus on an early entry into a new trend does not suit everybody.

There are many advantages in waiting for the trend to develop more fully before buying. This lowers the risk of the trade or investment because we have a clear understanding of how the trend is developing and can structure our investment or trading approach accordingly. There are three basic types of trend behavior. They are:

- Fast moving steep trend
- Longer term steady trend with limited trading activity
- Long term trend with consistent trading activity

How we decide to trade these trends and the entry tactic selected depends upon our understanding of the relationship between traders – the short term group of averages – and investors – represented by the long term group of averages. In all of these examples the focus is on the activity of the traders because the trends are underpinned by committed long term investors. Although not risk free, these opportunities offer low risk access to rising markets and the ability to manage the trade with less intensity. A quick glance at the chart every few days is all the management supervision required.

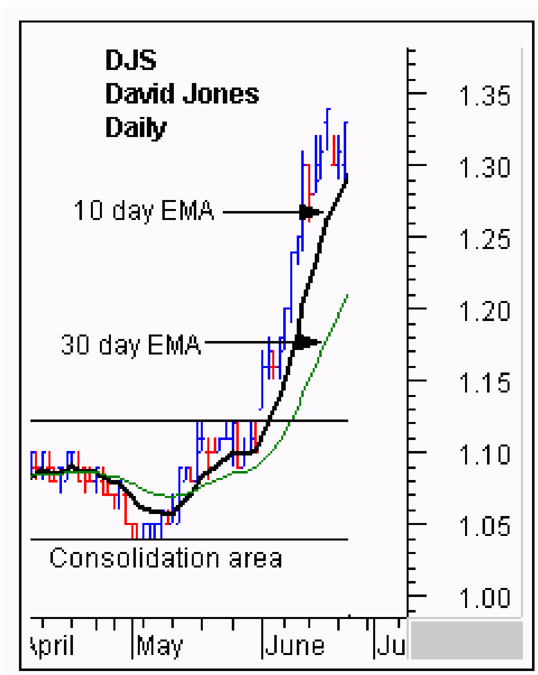
These market opportunities make use of the clearest of the GMMA relationships. We are not concerned with how the trend change was initiated. We are not called upon to make a judgment about the degree of compression at the point where the old trend changes to a new up trend nor is timing a vital issue. In the classic trend change situation discussed last week there are considerable advantages for those who recognize the trend change early. When we join an established trend the timing is less important because the rising trend is likely to continue for many days or weeks.

Our interest is in the nature and character of the established trend so we can decide the level of probability of it continuing. We look for low risk, high probability trend trades. Our intention is to either take a bite out of the trend, or to get out of the trend ***after*** it has started to deliver trend weakness or end of trend signals.

Both strategies are more difficult to execute than they appear. Logically, it makes sense to get out while the going is good – take a bite out of the trend. Or to get out as soon as possible after the trend has turned because we know we cannot reliably identify the very top of any trend move. In practice greed gets in the way. We want to take a very large bite out of the trend, or we hang on after the trend has turned waiting for the opportunity to exit at a higher price. The GMMA helps our analysis of the trend, but it is trading discipline that turns this analysis into trading success.

Fast moving steep trend.

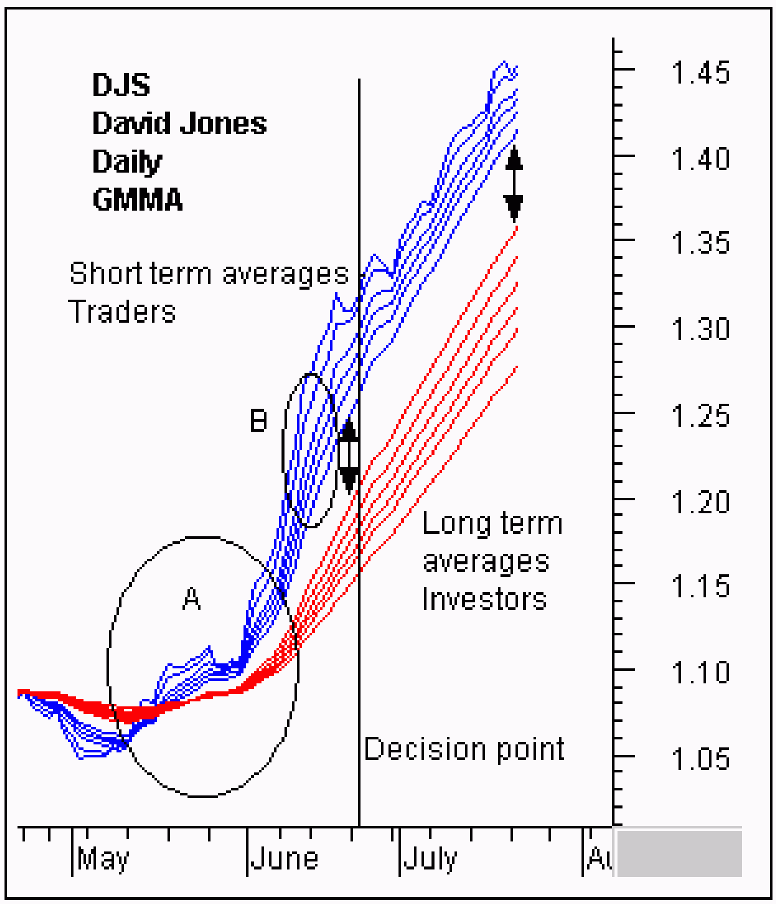
We do not have to be amongst the first to see an opportunity to be able to benefit from it. Often we see trends that have developed over several weeks and we have just one question. Is it safe to join the trend? This is even more relevant when the trend breakout from the consolidation area has been very steep as shown with DJS. Using the information available on the bar chart extract we need to decide the best trading tactics.



Using just the bar chart we are likely to avoid entering the trade. The trend run up has been steep and substantial. This has the characteristics of a momentum driven trade and these have a nasty habit of collapsing very quickly. The pause and decline in prices might be the beginnings of a trend collapse. On the other hand, this temporary lull may be the beginning of a trend continuation. To make a better decision we need to understand the character of the trend.

Often traders will rely just on two moving averages. The 10 day exponential moving average is shown as the thick black line. It is well above the 30 day moving average. The current price action is above the 10 day moving average but this just confirms that this is a strong fast moving trend. It gives us no additional information about the probability of the trend continuing. Once we move beyond a simple crossover analysis, the information provided by two moving averages is limited.

The information we can extract from the GMMA display is much more detailed and useful in making a decision about how we should join this trend. The vertical line shows the decision point on the bar chart extract. The first feature we note is that the activity of the GMMA in area A is not relevant to our analysis of the stock at the decision point line. It would have been difficult to accurately use the GMMA to identify the breakout from the consolidation area. This does not devalue the GMMA usefulness in making an assessment about the nature of the trend once it has developed.



The first thing we want to know is how the long term investors are thinking. This is an optimistic crowd. Once the up trend started the long term group of averages quickly separated into a broad band. The wider the band, the more stable the trend and the stronger it is supported. Although the slope of the trend is steep, the long term group suggests there is a scramble amongst investors to buy this stock. The development behavior of the long term group duplicates the way the short term group has spread out.

The behavior of traders also provides important information about the stability of the trend. If the trend break is dominated by speculative trading then we except to see considerable expansion and compression activity in the short term group of averages as traders sell out and collect quick profits. There is a small example of this in area A but this is the only instance of this activity.

The short term group of averages quickly separated and remained separated by around the same amount. By the time they reach area B the averages are moving broadly parallel to each other. The expansion has stopped, and there is little evidence of compression which characterizes trading activity. This trend is well supported by investors, and by traders who may have entered with a short term time frame, but who are now inclined to hold onto the stock while the trend continues.

Finally the degree of separation between the averages, shown by the double headed arrow, has stabilized. The two groups of averages are maintaining the same degree of separation and moving parallel to each other. Looking forward, the second double headed arrow shows how this degree of separation remained constant as the trend continued.

Although this is a steep trend driven by momentums the GMMA analysis shows it is a low risk trend trade at the decision point. In summary the GMMA provides this identification information for a mid trend entry.

- Short term group is well separated and moved into a parallel pattern
- Very little compression and expansion activity in the short term group means less speculative trading
- Long term group separated quickly and develops a steady parallel relationship. Group is widely separated.
- Distance between groups of averages has started to stabilize confirming trend continuity.

The GMMA provides the trader with a greater level of information about the nature, character and stability of the trend than can be obtained from other analysis methods. This information allows the trader or investor to develop a more appropriate strategy. In a sound well established trend, less management supervision is required and the entry price is not as critical to the success of the trade. In an unstable trend subject to high trading activity the entry price is important. Additionally these conditions call for a more frequent level of management, making them less suited for longer term investing.

In next weeks notes we look at better ways to use the GMMA to enter strong trends at a moment of price weakness.