STRATEGY #1 - Using Market Declines to Help Locate the Next Great Growth Story

By Jim Busch, Senior Managing Analyst
Combines fundamental analysis and quantitative screens to uncover small, fast-growing companies that have the potential to become market leaders.

Down or flat markets can be frustrating for most investors. The longer these corrective or churning phases grind on, the more natural it is to step away or "tune out" until the market becomes more constructive.

Yet if history is any guide, these difficult periods represent extraordinary opportunity for growth investors who know what to look for. In short, the price action you see in individual stocks during a correction provides specific clues that allow you to identify who the new leaders will be once the downturn has run its course. The type of price action I'm referring to is Relative Strength, which most Emerging Growth readers are likely familiar with. But given this summer's market volatility I thought I'd review the benefits of maintaining a Relative Strength watchlist during a market downturn.

Let's take a step back for a moment and discuss what precedes an intermediate-term market top. Typically, a few months before the broad market runs out of gas, the leading high-Relative Strength growth stocks undergo a "purging" phase. Basically, after a big run investors collectively take a fresh look at which stocks have the best prospects going forward, and which ones have already seen their best days. The sell-off in the latter group is often swift and severe, making this a particularly painful and oftentimes confusing phase for longs (again, this often occurs well before any broad market weakness manifests itself).

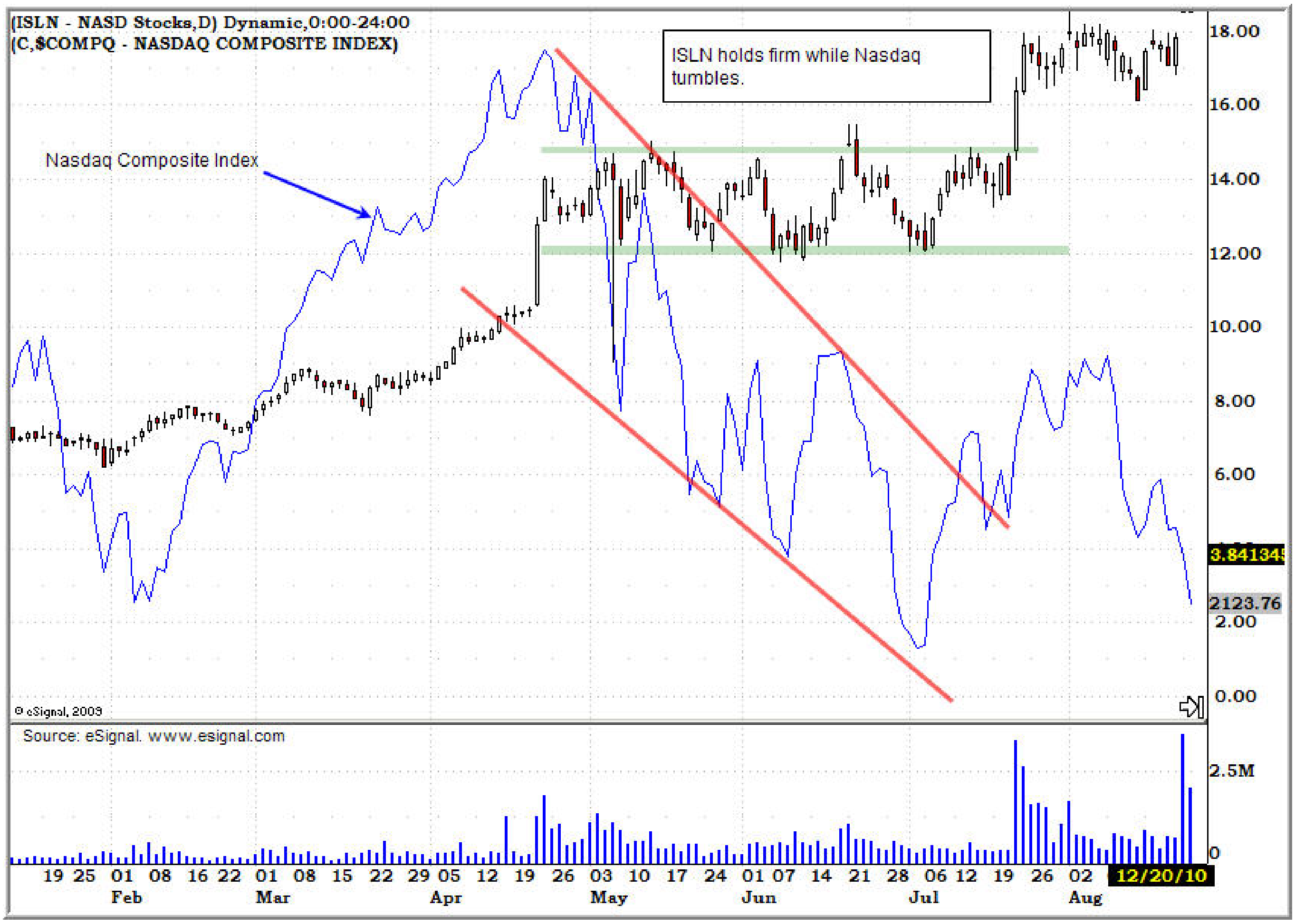
Once the broad market correction gets underway, if you know what to look for it becomes increasingly apparent which stocks fall into the former group -- those names that investors believe have the best prospects *going forward*. In short, a stock that holds up particularly well during a broad market downturn tells you very clearly that institutions are refusing to sell this particular name, and are likely adding to positions on minor weakness -- even while they're lightening up on their other holdings.

In short, the small number of growth stocks that show unusual Relative Strength during a broad market correction are providing clear evidence that these are the names that the "smart money" believes have the greatest upside once the current correction runs its course, and are positioning themselves accordingly.

Investors don't need any special software or data to screen for these new leaders -- they appear every Monday in the Emerging Growth Stocks rankings. The key is to know what to look for and when to act.

* * *

Let's look at a specific example. The chart below shows the clearest "leadership" pattern I've seen during the entire 2009-2012 bull market: Isilon Systems (ISLN). The chart shows how ISLN traded during the May 2010 Flash Crash and the subsequent 4-month correction lasting through August. (EMC acquired Isilon in the Fall of 2010, so unfortunately you can't pull up this chart anymore.)



As you can see, while the broad market (thin blue line) crashed in May and continued to sell off through August, ISLN (candlesticks) was absolutely bullet-proof. While hundreds of other stocks were plunging all around it, ISLN traded in a tight lateral range between roughly $12 and $15. As the summer wore on, this chart showed unambiguously that institutions not only refused to sell ISLN during the correction, but aggressively added to their positions whenever it approached the $12 level.

This ISLN chart is a textbook example of the type of price action you should be looking for during a multi-month broad market decline: sideways movement near 52-week highs, and the more orderly the better. Just keep in mind that "textbook" price action is exceedingly rare: generally speaking, unusual Relative Strength during a correction can be defined as sideways or modestly down from the 52-week highs (although in the latter case the stock shouldn't close under any major technical support zones). The very strongest stocks will even grind higher while the major indices fall, but you'll want to exercise caution with stocks that zoom higher during corrective phases, since they could be "relative safety plays" that see outflows once the market stabilizes.

Back to the ISLN example, this stock showed incredible Relative Strength as it moved sideways in a very orderly fashion while the market fell apart. Sure enough, when the broad market selling began to exhaust itself in July and August, ISLN (and a few other stocks that showed similar Relative Strength during that summer) were the first to break out to new 52-week highs.

So the principle here is actually very simple: during a broad market correction, build and maintain a watchlist of quality growth stocks that show outstanding Relative Strength (again, you'll find these every Monday in the Emerging Growth Stocks rankings). The price action can either be sideways, modestly down, or grinding higher, and preferably holding near the 52-week highs. The more orderly the price action, the better, since it suggests disciplined institutional accumulation. (In other words, avoid stocks that appear extremely volatile, or "whippy").

Finally, time is a crucial element here: the longer this type of price action occurs, the more bullish the pattern and the more powerful the breakout should be when the market finally turns.

* * *

Turning to the current summer 2012 correction, rather than getting caught up in trying to digest and act on every macro-related headline that's whipping stocks up and down, I've spent my time compiling a watchlist of growth stocks that showed the same type of consolidative action described above, because I know that these will be the leaders when the broad market begins a new leg higher.

So let's turn to a more recent example: Mellanox (MLNX), which had an earnings-related breakout just a week before the broad market rolled over in May.

In both the ISLN and MLNX examples, you'll notice that after a period of consolidation both stocks broke out to new highs without waiting for the broad market to put in a convincing bottom and begin a new uptrend. ***This is a key concept here: the new crop of leaders that emerge over the course of a downturn will almost always break out to new highs well before the major indices turn higher.*** More often than not, this is a "group move," where you'll see several of the new leaders begin to tighten up in their ranges just before they break out. Think of this final "tightening up" phase as the sprinters lining up at the starting line and getting into their crouch just prior to the gun going off.

We've seen the new leaders break out well before the broad market moves higher time and time again during the current bull market. Despite the grim headlines that were battering the market at the time, we saw this in February & March 2009, July & August 2010, late-August/early September 2011, and again in early June 2012.

Conclusion & Summary

Watching for these types of chart patterns will come naturally to technical traders, but investors who are more fundamentally inclined will also greatly benefit from looking at charts. Think of it this way: stocks that show unusual Relative Strength during a market downturn tell you very clearly that these are the names that institutions refuse to sell, and are accumulating on even minor pullbacks. Since most funds predominantly use fundamental analysis to pick stocks, you can extrapolate that these institutions must have solid fundamental reasons for accumulating these stocks near their highs while the broad market is grinding lower.

So to tie it all together, once it becomes apparent that we're in the midst of a broad market correction, watch the components of the Emerging Growth Stocks rankings to see which ones exhibit the following characteristics:

1. Orderly price action that holds just below the 52-week highs,
2. Shake-out attempts that bounce right back (these are brief but powerful clues), and then
3. Leaders showing signs of "lining up at the starting line." (In the MLNX example above, you see this occurring during the first week of June.)

Once you see price action that suggests item #3, that's the time to go long or place your buy stops just above the range.

To conclude, I hope that this discussion of Relative Strength watchlist and the examples given above prove valuable. If you have any further questions, please email me at emerginggrowth@briefing.com.

-- *Jim Busch*