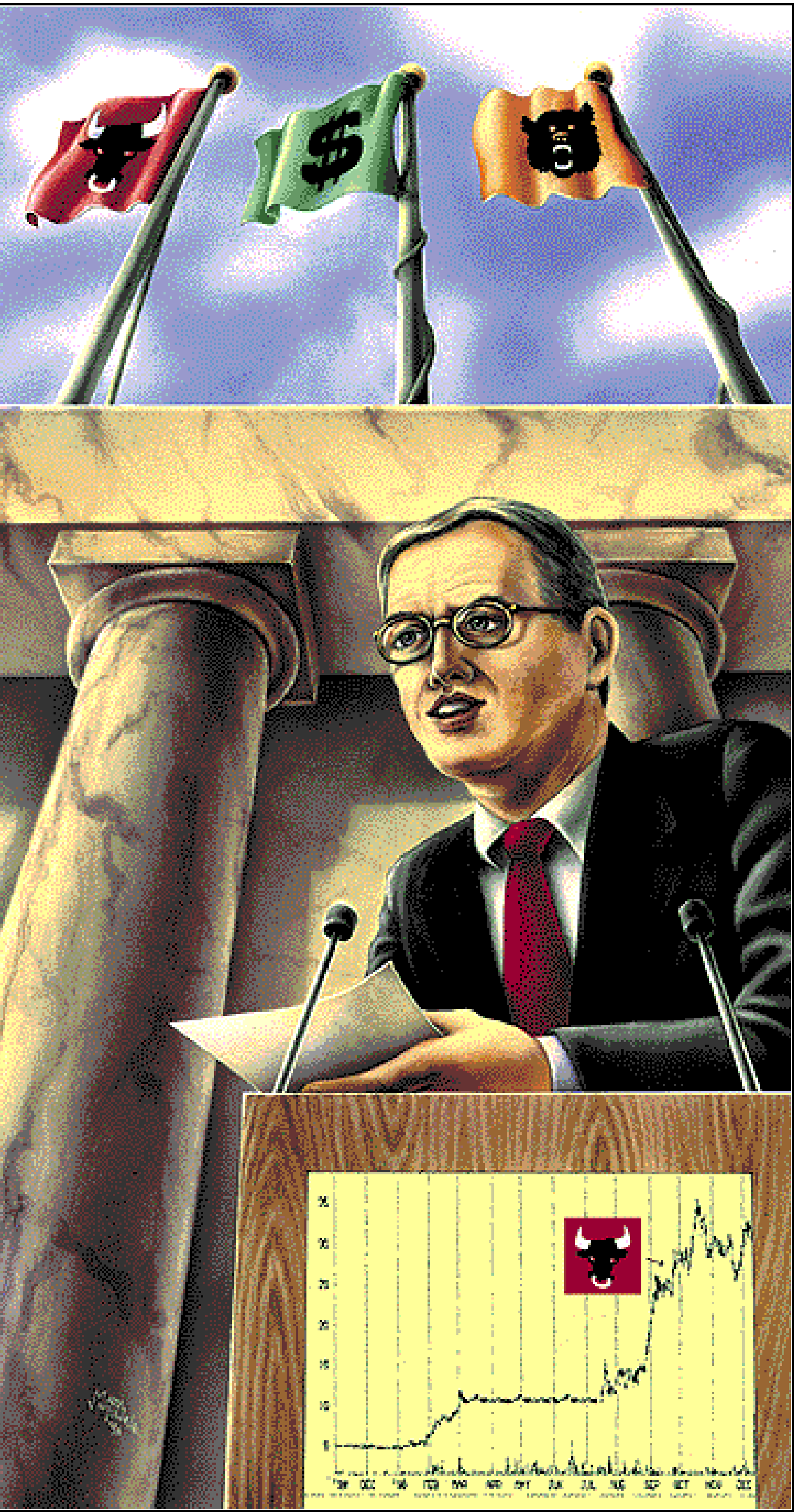
TRADING TECHNIQUES



MARK MOLNAR

The High, Tight Flag

During a strong trend, a stock will still spend some time in a consolidation period before the next run. Here's a chart pattern that can be found during a consolidation of a strong stock.

by Greg Kuhn

In most cases, when a stock skyrockets 40%, 50% or even 60% in just a few weeks, it's considered overextended and prone to a deep correction. This is true especially if the rally — often referred to as a *climax run* or *parabolic spike* — occurs at the end of an advance that developed over many months. Sometimes the situations could even be the beginning of an even larger advance, and often, such opportunities are forewarned by a particular chart pattern called the *high, tight flag*.

The high, tight flag pattern is a rare formation characterized by its occurrence after an advance that takes a stock up approximately 100% to 120% in just four to eight weeks, less in some cases. Following such a run, the stock usually corrects in a tight, sideways pattern lasting anywhere from three to six weeks, retracing no more than 10% to 20% of the advance. Many stocks can rise another 100% or more after the formation. The high, tight flag pattern consolidates an advance that often occurs after a stock has established a substantial base. The stock typically spends time in a well-contained base formation lasting from many months to many years. Then, some important news event usually emerges to lift the stock out of its dormancy — for example, an exceptionally strong earnings surprise or perhaps word that a major investor is taking a large position in the stock.

I was first introduced to the high, tight flag in William J. O'Neil's *How to Make Money in Stocks*. But I found the formation's cause-and-effect difficult to visualize until I could witness it in real time. This meant watching how a handful of the patterns worked before I was confident enough to trade it.

FIGURE 1: SCORE BOARD, 1991. *BSBL emerged sharply from its five-month base formation in September 1991, but this was only the beginning of a four-fold move. Note how volume swells following the breakout.*

FIGURE 2: SCORE BOARD, 1991. *The three-week, tight consolidation in early October was enough of a pause to set BSBL up for another double. Note how the volume dries up considerably as the flag forms, then surges on the breakout. This price/volume characteristic is typical in the forming of a high, tight flag pattern.*

METASTOCK (EQUIS INTERNATIONAL)

SALUTE THE FLAGS

The behavior of Score Board [BSBL] is a classic example of a high, tight flag pattern. Although I missed trading this one, it served as my template in properly identifying future patterns.

During its prior base formation, BSBL remained in a well-contained trading range before a news item acted as a catalyst to help the stock climb into orbit. BSBL's earnings growth had been decelerating for four quarters, but just as the stock was nearing the upper side of its five-month base formation, a major earnings surprise was announced and the stock took off, doubling in price in just four weeks (Figure 1). Although it appeared as if potential profits were lost by not playing the breakout, BSBL was really just warming up.

Upon completing its initial surge (the "flag pole," to continue the metaphor), the stock consolidated its gains in a 10% trading range (the "tight flag") that lasted exactly three weeks — the minimum required time to qualify it for the definition of high, tight flag characteristics (Figure 2). Almost immediately, the stock was off and running again. BSBL proceeded to double again over the following four months before falling back to earth (Figure 3).

The high, tight flag pattern consolidates an advance that often occurs after a stock has established a substantial base.

Another example of a high, tight flag formation presented itself during the summer of 1992. As a background note, the NASDAQ composite index had just completed a 15% correction and a multitude of stocks were setting up to break out from fresh base formations. For example, United Wisconsin Services [UWZ], an HMO provider, broke out from a six-month base formation in mid-July and was catapulted over

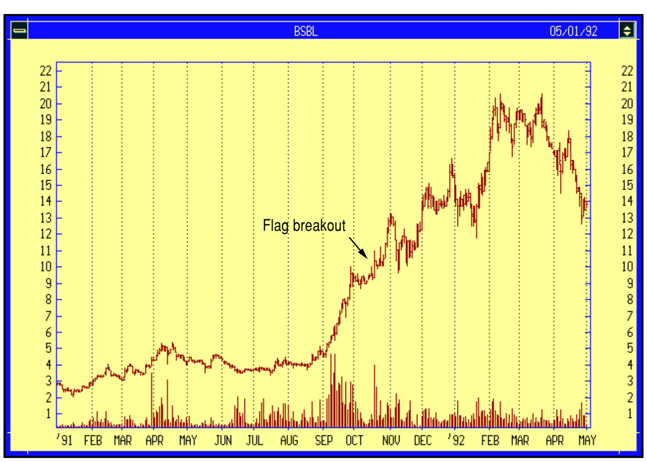


FIGURE 3: SCORE BOARD, 1991-92. *Obviously, holding this stock for a double was no joy ride. However, even if a trader was to use breakout strength into the end of October or December 1991 to take profits, it would have yielded a very worthwhile profit.*

FIGURE 4: UNITED WISCONSIN, 1991. *Here's another example of a company trading in a basing formation and emerging with the breakout accompanied by increasing volume.*

FIGURE 5: UNITED WISCONSIN, 1992. *Note how the right side of the flag, prebreakout, tightens up relative to the volatile action of the left side. Volume also dries up during consolidation, then strongly increases on breakout.*

FIGURE 6: UNITED WISCONSIN, 1992. *The price led to new highs after the completion of the high, tight flag pattern. The trend was broken when the company issued a negative statement.*

90% to its peak four weeks later (Figure 4). It didn't quite meet the typical minimum move of 100%, but obviously, it was close enough. The initial advance by United Wisconsin was in reaction to a strong earnings announcement. Then, UWZ spent the next five weeks in a tight trading range (or "flag"), and then emerged for another excursion of new highs (Figure 5). Although UWZ did not follow the usual doubling in price that most high, tight flags typically enjoy, the 40% gain it did offer over the next three weeks was worthwhile (Figure 6). The uptrend of this stock was aborted when the company announced that its corporate tax rate was going to go up.

YEAR OF THE FLAG

The year 1995 was a very strong one for the stock market. The quality of that market's trend was the best in many years — the kind of market ripe with high, tight flags. And there were many of them.

FIGURE 7: ZYGO CORPORATION, 1993-94. *Demand surges during the initial run, dries up as the flag forms and swells again on the breakout to new highs.*

FIGURE 8: ZYGO CORPORATION, 1994. *With the wind at its back, ZIGO hardly missed a beat during its tremendous run. Even selling into the miniclimax in mid-June would have turned a handsome profit.*

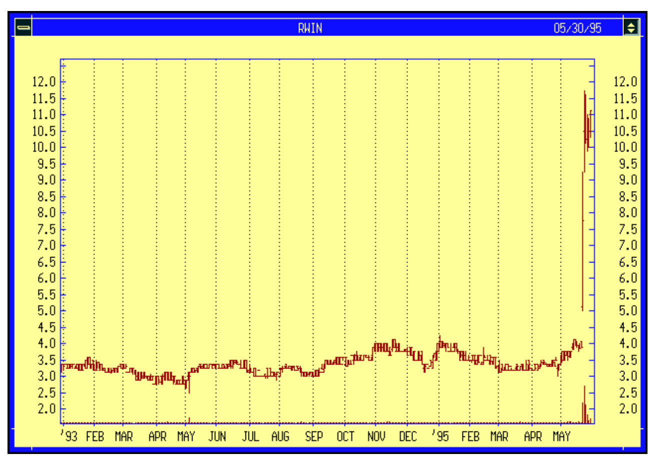


FIGURE 9: REPUBLIC INDUSTRIES, 1994-95. *Note RWIN's multiyear base and surging volume on breakout.*

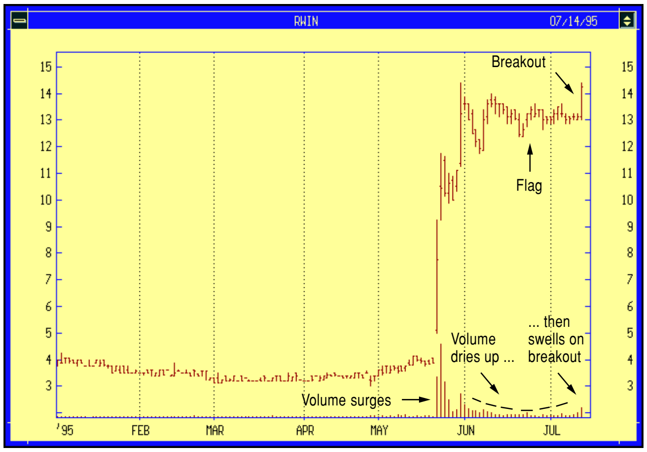


FIGURE 10: REPUBLIC INDUSTRIES, 1995. *After the fast run, the stock formed a high, tight flag pattern. The volume receded during the consolidation and expanded when the stock began to advance again.*

FIGURE 11: REPUBLIC INDUSTRIES, 1995. *After the breakout from the high, tight flag formation, the price of the stock advanced sharply.*

Zygo Corp. [ZIGO] fit the profile of a high, tight flag perfectly. It had spent three years locked in a trading range between $3 and $5 per share before shooting up to $12 in just four weeks. One of the best-performing stocks in 1995 for sure, ZIGO emerged from its flag pattern six weeks later (Figure 7). Unfortunately, what appeared to be a healthy profit when I took it turned out to be selling too soon. ZIGO spent the next six months on its way to a 250% advance (Figure 8).

Although most of the initial moves of a high, tight flag formation climb 100-120% over a four- to eight-week period, Republic Industries [RWIN] surged 250% in just seven days (Figure 9) after mega-investor H. Wayne Huizenga announced he was taking a major stake in the company. Nonetheless, the unmistakable flag formation that followed qualified it as a high, tight flag. The flagging price action lasted exactly six weeks and stayed in a tight trading range of about 15% (Figure 10). The coiling or pennant effect toward the end of the flag set RWIN up for what turned out to be a breathtaking move — nearly double in just eight days (Figure 11). Unfortunately again, I became concerned about a possible setback and only stayed for the first half of the party — a 42% profit in five days.

FAILURES

When correctly identified, the high, tight flag formation brings instant gratification. But it can also bring instant aggravation if your appraisal is incorrect. Such was my case with Centocor (CNTO) in January 1996.

By studying the successful examples, high, tight flag breakouts should be accompanied by an increase in volume of at least 40% above the 50-day average volume. Although CNTO's short flag pole looked very similar to RWIN's and its flag qualified in terms of its

FIGURE 12: CENTOCOR, 1995-96. *The volume did not increase, indicating poor demand on CNTO's flag breakout, and hinted at its eventual demise.*

FIGURE 13: CENTOCOR, 1995-96. *The lack of volume forewarned of a retest of support at the lower side of the high, tight flag.*

extent and duration, volume was unable to surge much on the breakout, indicating waning demand at that point (Figure 12). In addition, unlike the other examples, CNTO's flag breakout was being challenged by some major overhead resistance from prior years (not pictured). Whether the prior resistance or lack of demand on the breakout is to blame, the result was a failure (Figure 13). The eventual bounce back in price to new highs was anyone's guess. Overall, the pattern was aborted.

CONCLUSION

Using models or templates of past winning chart formations is an excellent way for a stock investor to identify future candidates. O'Neil explains that the high, tight flag formation is the strongest, but riskiest, pattern and difficult to interpret correctly. I hope the examples I have used will serve as templates to help you correctly identify future high, tight flag candidates. These patterns *do* repeat time and time again, but you have to be on the constant lookout because the good ones are rare.

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RELATED READING AND REFERENCES

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†See Traders' Glossary for definition

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