The Advance–Decline Line

By

DAVID H. SUTTON,
B.Com., A.A.S.A.

To American investors one of the most valuable and respected technical market indicators is the Advance-Decline Line. This indicator, which has the advantage of ease of calculation and interpretation, is widely used as a guide to the strength or weakness of the market.


In his article Freeman says “The Advance-Decline Line is not only a useful key to the market’s long term position but also a fine-focuser on lesser turning points. In fact, no other technical indicator is quite so consistent in picking market tops, as well as in picking market bottoms. It shows the relative movements in the number of stocks whose price rose (or advanced) in any one day’s trading and the number of stocks whose price fell (or declined). Most newspaper accounts of the day’s market action include the total number of stock whose price gained from the previous day’s close and the number which posted losses. The A-D index is derived by subtracting the declines from the advances. These differentials which will be minus numbers whenever declines exceed advances are added each day to form a moving average. When plotted on a chart as a series of connected daily totals these cumulative differentials form the Advance-Decline Line. This relationship between the number of stocks rising and falling illustrates the underlying strength of the market and the trend of the index when plotted on the graph reveals whether the market is rising, in balance or falling. This results in an easily interpreted barometer of the market strength. The number of days’ trading included in the calculation depends on the requirements of the investor. An index which is based on ten days’ trading will be sensitive to short term fluctuations while an index which is required to show longer term movements will use up to three months’ trading information.

The accompanying table illustrates the computation of a 10-day index.

On the above dates (column 1), the daily press reported the rises and falls of all stocks traded as listed in columns 2 and 3. The net difference (column 4) for the 10-day trading period (1 May-14 May) was totalled and appears in column 5 as the beginning of the index. On May 15th the difference between the advances and declines was + 137. This figure is added to the index and the May 1st difference of + 70 is deducted thus maintaining the index as the cumulative total of the previous 10 days’ movements.

To determine whether this market indicator could be applied to the Australian situation as successfully as it has in the United States it was decided to calculate and plot a 10-day index Advance-Decline Line and compare it with movements in the Melbourne Stock Exchange index of the 50 Leaders. The period chosen was the six months from April 1, 1968, to September 30,
1968. This was considered to be a suitable period for the test because it was one during which the market was both strong and weak and so opportunity existed for the Advance-Decline Line to demonstrate its characteristics.

On the chart the 50 Leaders Index displayed the following movements. The index rose strongly from the April 1st level of 187.23 to 237.32 at the beginning of June. During June the rate of increase was not as strong, but the upward continued into July, with the index reaching a peak of 250.80 on July 9th. From this point a brief plateau was formed and the index turned down, from 251.60 on August 19th, the decline gathering momentum in August and September.

The Advance-Decline Line displayed similar strong characteristics in April rising from 288 on April 1st to 955 at the end of the month. A peak was reached on May 3rd at 1004 and from that point the line turned down. The A-D index almost reached the May peak early in June when it touched 957, but was not able to maintain the upward trend and fell sharply throughout the rest of the month. Over this period the 50 Leaders Index continued to rise, despite the fact that the strength of the market, which was displayed in April and May, was waning. The reaction which technical market analysis said would come sooner or later commenced early in May when, for much of the month's trading, falls exceeded rises, and was most pronounced in June when price falls constantly outnumbered the rises. The relationship between daily rises and falls changed on May 4th but it was not until July 10th that the changing situation was reflected in the 50 Leaders Index.

An analysis of the graph emphasises the fact that the A-D Line fell during June while the index continued to rise. By its action the A-D Line was warning that the market was weakening despite the rising index, that is, providing an indication that the index, sooner or later, was about to follow. At no particular point can it be said that the A-D Line said to sell, or that it would predict how far the market would

(Continued Inside Back Cover)
to the accounts showed a net profit of $5,003,184, representing 26.8% on ordinary capital. To most readers this represents the amount available for reserves and dividends, that is, for the benefit of shareholders. However, this is not the case here because an amount of $530,000, more than 10% of stated net profit, was then appropriated to the Employees' Profit Sharing Fund. In other words, the profit available to shareholders was really $4,473,184, being 24% on ordinary capital, which is markedly lower than stated by the directors. While it is conceded that the amount available for Employees' Profit Sharing Fund can only be ascertained after the net profit has been struck, and in this particular case the auditors have shown it clearly in the accounts, as far as shareholders are concerned this is in the nature of a bonus to employees and as such is a charge against profits before reaching the final net profit figure, which is of paramount interest to shareholders.

There are a number of instances of companies displaying undue conservatism in their accounts; some of these have recently found themselves targets for takeover bids and have had to take evasive steps to thwart would-be suitors.

The writer concludes that there should be more action taken by influential bodies to compel companies transgressing the principles of the type outlined above to show "true" profits rather than "desired" profits.

---MEMBERS---

Contributions to the Journal to be Forwarded to:

The Editor,
Australian Society of Security Analysts,
Box 5085, G.P.O., Sydney.