Six different strategies you can use to invest in the stock market – and one way to dominate it

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I meet a lot of people who know very little about the stock market, but want to know how to make smart investments that will grow their money while avoiding too much risk. This article is for those people.

Finding information on ways to invest in the stock market isn't exactly hard. It's actually the opposite problem; it's overwhelming how much information is out there. Your local bookstore has sections full of books on different strategies you can use to make investment decisions. How in the heck are you supposed to decide what stock market investment strategy is right for you or even works?

The good news is, I've read most of those books. I've applied the methods that each one of them preaches. And after spending the last 20 years of my life staring at the market all day long, I've come to learn what works and what is a waste of your time. The better news; making smart investment strategies is nowhere near as complicated as the majority of those books would lead you to believe.

I'm here to simplify it for you, to show you the most popular methods that people use to invest and to briefly discuss the pros and cons of each investment strategy. You will find that, with a lot less work than you'd expect, you can invest in the stock market with confidence while sacrificing very little time. And maybe more importantly, you will learn that you don't need to invest in fear; you can use a strategy that will keep your risk of losing money small at all times.

Let's start from the beginning. The goal of investing in the stock market is obvious. You want to buy the market when it is going up so that the thing you bought for $10 is now worth $15 or maybe $40. Conversely, you want to sell the market when it's going down. This chart of the Nasdaq (which is a gauge of the overall stock market) shows you the best-case scenario of buying and selling over the past 25 years. If you took $1,000 and bought the Nasdaq perfectly at its major lows and sold it right at its major highs, you would have turned your small investment into $223,000.

Yep, that's what we're all here for – learning how to make our money work harder for us than we can reasonably work for ourselves. So how do we figure out what and when to buy and when to sell so that we can dominate the stock market and retire early? That is the gazillion dollar question.

Let’s kill the suspense. No investment strategy is going to tell you exactly when the stock market is going to turn and leave behind a major high or low.

Instead, the real goal, no matter who you are or what trading method you use, is to simply get in the way of the biggest stock market advances (or trends) that you can find and to ride that trend as long as you can so that your stack of money grows.

At the same time, you have to keep the risk that you’ll lose money as low as possible. I’m going to show you how to do this in the most effective and efficient way I have found from two decades of research. First, you need to become familiar with the different stock market strategies that are available to you to better understand what works and what doesn’t.

Fundamental vs. Technical Analysis

The goal of any stock market strategy is to identify investments that are going to go up. There are two general methods you can use to accomplish this goal.

One method is to analyze a company whose stock you want to buy, to determine if there is a reason the stock should be worth more than what it’s trading for today. You become an accountant – you study the company’s financial books to determine if they are a good investment. By doing this, you hope to uncover something that tells you the company’s stock is either cheap and should become more expensive, or something that says the company is ready to grow like a wild fire. This is fundamental analysis, and it is how most investors make investment decisions.

The second method you can use to find great investments is to look not at the health of the company, but at the health of the company’s stock. So instead of looking at a company’s financial books, you would look at a chart that plots the daily price movement of the stock. The reason behind this approach is simple: If the price of the stock is going up, then the stock market must deem it a good investment so maybe it’s worth investing in.

After all, there are a lot of smart people who spend all day every trying to figure out how much a stock should trade for. I doubt I can uncover something that they didn’t. Every factor that can affect the price of a stock at this moment should already be reflected in the price of the stock, so technical analysis focuses just on how the stock is doing.

The technical analyst looks at a stock’s chart and tries to determine which way the price of the stock is going to go. This is a much more visual approach:

Pop quiz. Look at the price chart above and the price chart below. They both represent the last 10 years of price movement on two widely-traded companies. Which one looks like a better investment? It’s a no-brainer. If you would have invested $10,000 in the stock below (a company called Apollo Group), today that investment would be worth $1,670. If you would have put the same amount in the stock above (a small outfit by the name of Apple), you'd be sitting on $245,000. The goal of technical analysis is to look at the price chart of any given stock and try to determine if it's about to become an Apple or an Apollo.

That is the 30,000-foot view of the two major stock market investment strategies. Let's dig deeper into each type to better understand some of the ways investors use fundamental and technical analysis to make investment decisions.

Fundamental Analysis Strategies

Company-focused (or bottom up approach)
The main way investors use fundamental analysis is to analyze the financial health of a company to determine if it is an investment they want to take. The investor takes a fine-toothed comb and looks at the financial statements of the company to see if they are growing and how they compare to their competitors.

You might look at a company's earnings growth from year to year, earnings per share, how much debt or cash the company has, or some other measurement of a company's financial health. If your analysis tells you the company should be worth more than its stock is trading for, then you may choose to invest in it with the hope that other investors will come to the same conclusion and push the price of the stock higher.

Pros: The best part about analyzing a company's financial health so closely is that you begin to truly understand that company's business. You will develop a feel for how external events might impact the price of the stock, and if you do uncover a gem that has not yet realized its full potential, you can get in on the ground floor of a massive stock price move that will have a big and positive impact on your investment portfolio.

Cons: This is a very information and time-heavy approach. Learning one company from the inside out could take a good chunk of your time; getting familiar with the 4,000 companies that are widely traded in the US could be your life's work, and that would be ignoring the 15,000 lightly-traded companies that are out there as well. Unless this is your career or you're retired, it's near- impossible to find the time to use this investment approach.

There are massive financial institutions that have departments and a lot of financial resources dedicated to this task. There is zero chance that I can keep up with their efforts. Personally, this is not the approach for me because the time commitment is huge, and I have no competitive advantage.

Economy-focused (or the top down approach)
Another fundamental analysis that can be used to make investment decisions is to take a broader view; looking at the overall economy to figure out if the entire stock market is going to go up or down. So instead of spending your time looking through a company's financial statements, you'll spend your time looking at the country's financial

statements. You'll track the Gross Domestic Product (GDP), follow job reports, housing starts, inflation rates – anything that gauges the health of our economy.

From there, you'll try to focus in on the strongest sectors within the economy, and then find the strongest stocks within that sector that are worth your investment dollars. In the end, you hope to be left with only the strongest investment opportunities in the strongest sectors within the strongest economies.

Pros: You cannot underestimate the importance of the overall stock market direction when investing. Since 2009, you could throw a dart at your financial paper to randomly find a stock that would have made you good money, because the stock market has been going up since then. On the flip side is that most stocks will do very little for you when the market is going down. This approach gives more credit to the importance of overall stock market direction, and that is absolutely a good thing.

Cons: This is also a time-heavy approach. You could spend all day looking at government economic reports. Not only that, but the stock market and the economy don't always dance together. Sometimes the stock market goes up during bad economies. Sometimes the stock market sells off when a really good jobs report comes out. The correlation between the two simply isn't as direct or logical enough for me to use this investment strategy.

Stock Picker

Maybe the most common approach to investing in the stock market is the stock picker approach. This is a less-scientific way to identify investment opportunities. The idea is to find "hot stocks" that are about to explode, based on new products or new technologies that you think are going to change the game. You might find these opportunities by watching the news or reading trade publications, or any other method that unveils unproven but potential-full ideas.

A subsection of this type of strategy is the newsletter follower or stockbroker follower. It's not hard to find someone that's willing to sell you their ideas on what they think are great investment opportunities. Heck, I'm one of them. You just better hope you pick the right horse because you are putting a lot of faith into their opinions. Do they explain why they are recommending a stock? Do they provide only hazy recommendations and then take credit for only the recommendations that work out? Do they tout unrealistic gains? These are some of the warning signs you need to be looking for.

Pros: If you (or someone's advice you follow) does uncover stocks that are at the forefront of game-changing products or technologies, you can land massive gains for your investment portfolio.

Cons: This investment strategy is a crap shoot. For every game-changing technology or product, there are thousands of technologies and products that just didn't quite register. And even if you are onto something big, you might invest in the wrong company in that space. Think Myspace. This is a risky approach, one that may be fun to tinker with but should not be your main stock market investment strategy.

Fundamental analysis can be very fruitful if you have a ton of time on your hands for research and have the benefit of a strong stock market behind you. It's not the best approach for me. Let's look at the other option:

Technical Analysis Strategies

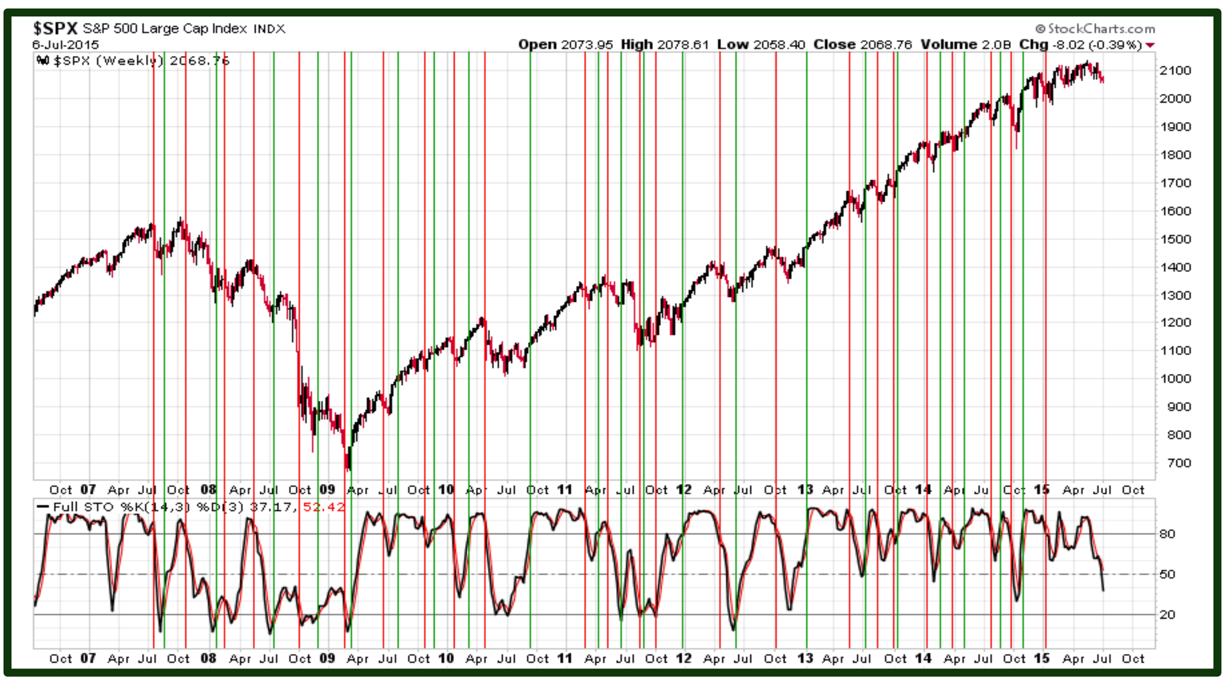
Technical Indicators

Recall that technical analysis is the process of looking at a stock's price chart (instead of the company itself) to find good investments. One of the main ways investors do that is by using technical indicators. Technical indicators apply some formula to a stock's price, with the hope that the formula will provide greater insight into whether that stock is going to go up, down, or sideways.

We don't need to go over every technical indicator out there because there are hundreds of them and most of them work the same way. Instead, let's look at one example.

This is a chart of the S&P 500. Below the price chart, you will see a squiggly line that represents a technical indicator. This one is called Stochastics. This squiggly line "oscillates" back and forth between 0 and 100 in an effort to determine when the S&P 500 is in a strong up trend, when it's in a downtrend, and when it has moved too far in one direction and is due for a move in the opposite direction.

The true purpose of a technical indicator is to tell you when to buy a stock and when to sell a stock. For Stochastics, the general rule is to buy when it moves above 20 and sell when it moves below 80.



Here is a look at the buy and sell signals that Stochastics issued over the last eight years on the S&P 500. Boy that's a lot of buying and selling, especially when the S&P 500 has spent the last six years moving mostly in one direction. Personally I'd rather just hold onto my investment when it's going up and sell when it's going down. Yet, despite all of the noise that this technical indicator creates, this is what most people think of when they are talking about technical analysis. No wonder technical analysis scares so many people!

Another type of popular technical indicator is a moving average. This type of indicator averages the price of a stock over a set number of days to uncover the underlying direction of a stock's trend. The goal here is to get rid of the noise that is created by each day's price movement and focus just on the trend.

This price chart shows a red line that represents a 200-day moving average of the price movement on the S&P 500. You can see how it smoothes out the daily fluctuations.. Some investors will own a stock if its price is trading above the red line and sell it when it's trading below that line.

Pros: Technical indicators are focused on the one thing that determines how well your investments are going to do – the price of your investment itself. Also, they help you avoid disaster in your investment portfolio. If the price of a stock you own begins moving lower for a sustained amount of time, these technical indicators will tell you about it and will move your money to safety.

Cons: Technical indicators can create a lot of unnecessary noise. If you look at the chart above, you can see how Stochastics wanted you to buy and sell a lot more than you should have.

Additionally, there are some really smart people out there who build computer programs looking for the perfect combination of technical indicators that will give them the ideal stock market investment strategy, based on what the market has done in the past. These are called mechanical trading systems. The results of these systems, and the results of investing based on the buy and sell signals of any individual technical indicator, are not good. The performance of most of these trading systems is worse than if you would have just bought and held onto your investments.

Maybe even worse, some of these technical indicators work great for a period of time, and then seem to stop working altogether. It can be really costly using a broken investment strategy – you never know when to stop using that strategy and move onto the next one.

Using technical indicators can provide some insight and sometimes even warn you when a trend is going to change. But despite the way many people use it, this is not a complete stock market investment strategy, and it certainly doesn't hold the answer to stock market domination.

Support and resistance

Another way to analyze a stock's price chart is by using support and resistance. In the simplest terms, this investment strategy consists of drawing a line on a stock's price chart to identify up trends and down trends.

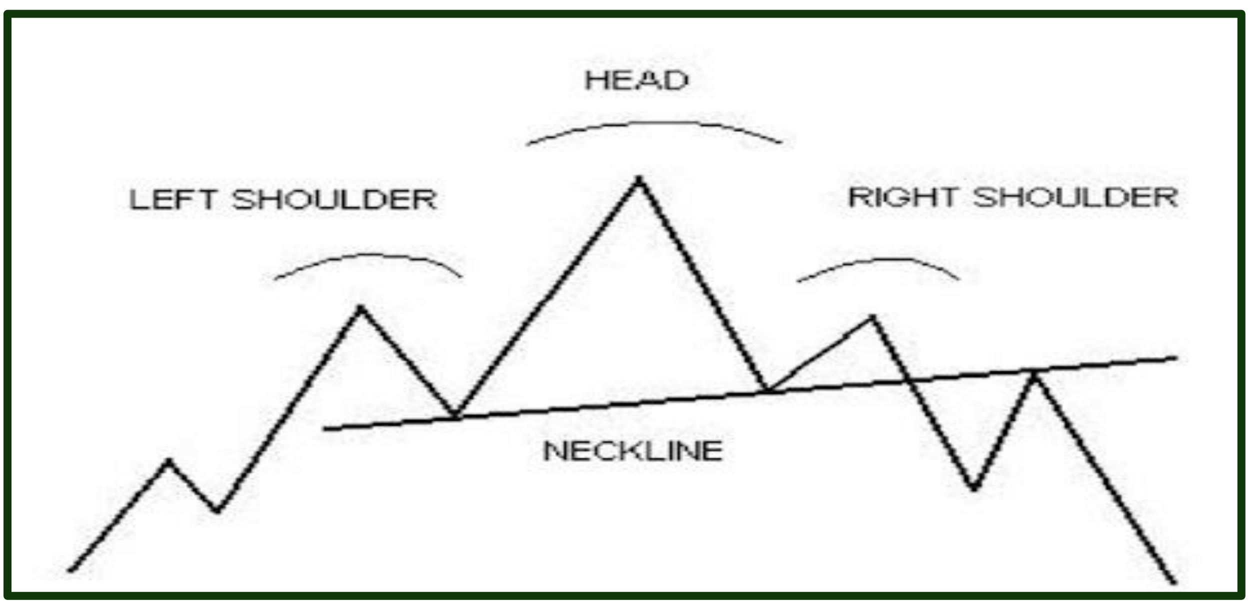
This chart gives some examples of a few support and resistance lines. The idea is to draw a line along the lows that you find below a stock's price (or along the highs in a downtrend), and as long as the stock's price stays above this line, you will own the stock. Once the line is broken, you sell.

Pros: The simplicity of this method is brilliant, and it will keep you invested in a stock for a big portion of its biggest price moves.

Cons: It may seem easy after the fact, but it's really not that easy to figure out where to draw your support and resistance lines. So you may be inclined to ignore the rules of this investment strategy. For example, when a stock's price does move below a trend line you've drawn, it's fairly easy to ignore the fact that you should sell your investment, because you might have just drawn your line incorrectly. There is too much subjectiveness involved for me to use this investment strategy.

Pattern Recognition

Another way to use a stock's price chart to find good investment opportunities is to look for patterns in the price movement. These patterns are basically warning signs that something is about to happen.



This chart shows an example of a Head and Shoulders pattern. It is supposed to warn that a high in a stock's price is looming, and is used as a reason to sell your investment. Other patterns include a cup and handle formation, double tops and bottoms, and a triangle pattern.

Pros: Once you get familiar with the way these patterns work, they can provide insightful clues that are worth paying attention to.

Cons: It takes some time to learn and gain experience with the potential patterns that might occur on a stock's price chart. And while these patterns do work sometimes, they don't work all the time. Furthermore, you might start to see patterns that don't really exist. It becomes a pretty subjective strategy that is tough to commit to. Trying to identify patterns in a stock's price action does not provide you with a good way to dominate the stock market.

Trend Following

We've spent a lot of time looking at the most popular approaches to stock market investing, including what is good about each strategy but why each one of them falls short of what we are trying to do. Now it's time to look at what works; trend following. This strategy uses the only thing that matters to the success of your investment – the movement of a stock's price itself, nothing more and nothing less.

If a stock is moving higher, I can see it by looking directly at the price movement of that stock. I don't need to know why it's moving higher. And I don't need to confuse the matter by looking at a bunch of technical indicators or trying to find a specific price pattern that would cloud an otherwise clear picture of a strong price move.

Trend following is based on the fact that the stock market moves in one direction (or trends) for a sustained period of time.

If you look at the last 30 years of price action in the stock market, it becomes pretty clear that it does indeed trend. All we have to do is pay attention to the direction of the current trend and get in the way.

There are several different ways to follow a stock's (or the entire stock market's) trend. One way is to buy the stock every time it moves to the highest level it has been in, say, four weeks. This is called buying breakouts. Another way is to use a method called the Elliott Wave Theory, which seeks to identify the difference between price action that is trendy and price action that is moving against the trend. You simply buy into trendy price action and hold your investment until the trend has apparently changed.

It can't be that simple; can it? Look at the price charts of 20 different stocks. Can you tell if each stock is trending upward, downward, or sideways? Of course you can. Can you tell which ones are in the strongest trends? Absolutely. Look for the ones that are moving higher the quickest. The companies behind these quick movers must be doing something right, so why not own them?

Don't worry about how long the stock has already been moving higher. Many of the biggest gains you will find are on stocks that have already enjoyed big gains. Take the Apple example above. When it moved from $10 to $20, it was probably "too expensive" for a lot of people to buy it. But it kept going, all the way to $130. Never underestimate how far a stock can move; just simply find the strongest ones and buy them.

Create a set list of stocks or other instruments to follow on a regular basis, say the 100 stocks that make up the Nasdaq-100 or the 38 Exchange-Traded Funds (ETFs) that we follow on our website at Trendlizard.com. Look at their price charts once a week or even just once a month. Identify the stocks that have the strongest trends, and simply buy them. Keep an eye on your holdings and if the trend you invested in changes, exit the position.

A more specific way you can decide when to sell your investment is to look at the trend you are investing in, and figure out how big the biggest pullback was during the trend to that point. Say it was a 6% pullback. You can then decide that you will sell your investment if it pulls back more than 6% at any time.

Pros: A trend following approach is super simple and takes very little time. You will never miss a major move in any market you follow. You will remain focused on the only thing that matters to the success of your investment – the price movement of the investment itself. And maybe most importantly, this strategy ensures that you will get out of an investment that is going against you, which means you will always keep the risk of losing money low.

Cons: You will take some losses because you might buy into a trend that is nearing its end. In fact, most trend followers will readily admit that they only make a profit on maybe half of the investments they make. The success comes from making your gains a lot bigger than your losses, which is precisely what this strategy puts you in a position to do.

Domination

The goal of every stock market investment strategy is the same in the end. You want to find a stock that is in a big price move (or trend) and to ride that move as far as it will take you.

Some investors look at a company's books to find stocks that should be moving higher. Others look in newspapers or newsletters for tips on which stocks could be the next Apple. The more visually or mathematically inclined might use an abstract technical indicator or search for patterns in the stock's price to uncover winning investments. These are the most popular techniques for investing in the stock market – and yet they're not the best way.

All of these approaches dance around the only thing that matters to your investment success – the price of your investment itself. This is the only thing that affects how successful you are at investing. Why not focus your stock market investment strategy on the only thing that matters? You don't need to know why a stock is making a big move. Just focus on the fact that it is in a big move, invest in the big move, and enjoy the ride.

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