

If a Stock Drops 5 Days in a Row, Should You Buy It?

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What happens to stocks that close up, or down, consecutive days? Most people would say stocks that close up consecutive days are strong, and stocks that close down consecutive days are weak. This type of thinking makes perfect sense. After all, it feels good when a stock you own keeps going up, and bad when a stock you own keeps going down. Therefore it's only natural to think strong stocks go up and weak stocks go down — therefore you should buy strong stocks and sell weak stocks.

However, our research shows there is an edge in stocks that have declined three or more consecutive days.

Consecutive Up/Down Days

We looked at over seven million trades from 1/1/95 to 6/30/06*. The table below shows the average percentage gain/loss for all stocks during our test period over a 1-day, 2-day, and 1-week (5-days) period. These numbers represent the benchmark, which we use for comparisons.

We then looked at stocks that made exactly three consecutive up/down closes, all the way to stocks that made exactly seven consecutive up/down closes. Here's what we found:

Consecutive Up Days

Stocks that closed up exactly three consecutive days, on average, underperformed the benchmark 1-week later (+0.14%).

Stocks that closed up exactly four consecutive days, on average, underperformed the benchmark 1-week later (+0.02%).

Stocks that closed up exactly five consecutive days, on average, showed negative returns 1-week later (-0.11%).

Stocks that closed up exactly six consecutive days, on average, showed negative returns 1-week later (-0.30%).

Stocks that closed up exactly seven consecutive days, on average, showed negative returns 1-week later (-0.40%).

As you can see, the statistics show even greater underperformance each step of the way.

This research shows that traders should avoid buying stocks that make consecutive up days and aggressive traders may consider short selling these stocks.

Consecutive Down Days

Stocks that closed down exactly three consecutive days, on average, outperformed the benchmark 1-week later (+0.36%).

Stocks that closed down exactly four consecutive days, on average, outperformed the benchmark 1-week later (+0.54%).

Stocks that closed down exactly five consecutive days, on average, outperformed the benchmark 1-week later (+0.63%).

Stocks that closed down exactly six consecutive days, on average, outperformed the benchmark 1-week later (+0.82%).

Stocks that closed down exactly seven consecutive days, on average, outperformed the benchmark 1-week later (+1.06%).

In this case, the statistics show even greater out-performance each step of the way.

This research shows that traders should look to build strategies around stocks that make consecutive down days.

Our research shows there is an edge in buying stocks that have declined three or more consecutive days. It also shows this edge increases when we extend the sequence to five, six, and seven consecutive days. Conversely, our research shows stocks that have risen three or more consecutive days should be avoided. Short sellers should consider taking a closer look at stocks that have risen five or more consecutive days.

Once again we find statistical evidence that shows short-term strength is usually followed by short-term weakness and short-term weakness is usually followed by short-term strength.

Just like the other articles in this series (view archives), these returns can be improved even further by adding simple conditions, like filtering stocks based on whether they are trading above or below the 200-day moving average (see below), days of the month, and/or combining them with PowerRatings, etc. §