

Spotting Tops and Bottoms

"Tonight's all about staying one step ahead of the game," Jim Cramer told viewers of his "Mad Money" TV show. "If you can spot a big move in a stock or the whole market before it happens, you're made in the shade."

If there's one thing Cramer's done well during his career on Wall Street, it's spotting bottoms, he said.

There are no specific techniques, formulas or hard-and-fast rules for spotting a bottom, which is when a stock hits its low point and is ready to move higher. Nor do real bottoms come around often, he said, but when they do, "if you call them correctly, you can stand to make a small -- actually not so small -- fortune."

While a lot of people rely on pure technical analysis and look at charts to spot a bottom, a chart is not enough, he said. People need to consider the fundamentals, too, because "sometimes a stock that goes into free fall is only taking a breather before sprinting towards zero."

Cramer said he's also never seen a stock bottom out based on earnings reports. "The thing about a bottom is that if too many people see it coming, it won't happen," he said.

Another "crucial" fact about bottoms is that they rarely happen all at once, Cramer continued. While not always the case, usually the market bottoms in thirds and sector by sector over a period of days, he said.

Market players should see three things when looking for a bottom. First, "market sentiment must be bad," Cramer said. "When the malaise reaches all the way up there, that's a terrific indicator that we're nearing a bottom."

Second, investors should look out for mutual funds pulling out of the market in a "significant way," he said. "To correctly spot a bottom, you need to be right when almost everybody else in the market is wrong," Cramer explained. When the mutual funds give up, you get a massive "crescendo selloff," which is "one of those rare times when the market bottoms all at once, not in thirds."

Finally, big bottoms usually have a catalyst, such as a subprime lending crisis or a **Fed** rate hike, when the market sentiment is already in the gutter, he continued.

"Understand, the market hates nothing more than uncertainty," Cramer said. In the 24 hours leading up to both of the wars in Iraq, he said, he managed to catch great bottoms because investors couldn't handle the total lack of certainty.

Switching gears from bottoms to tops, Cramer told viewers that even though people don't like to talk about tops on Wall Street, it is imperative to spot one to avoid "some serious pain."

"Sooner or later, every stock, every market, reaches a point where it can go no higher and in fact starts going a whole lot lower, maybe for years," he said. "It has happened historically without fail," and even if you don't want to, you must sell a stock when you see it's nearing a top.

One of the best ways to tell that a stock, especially one that's had a lot of momentum, is played out is when the bears start disappearing and analysts who cover the stock have upgraded, Cramer said. "That's a great sign in a momentum stock that you're about to run smack into a top ... because everyone who wants the stock owns it, and that means the buying will stop soon."

The second reason to abandon a stock is competition, he said. The only way you can tell that the competition is about to come in and destroy your company's business is by being watchful, Cramer said, and "the price of profits is eternal vigilance."

It's not enough to merely do homework on your stock, you need to monitor the whole sector, Cramer stressed. "I'd say a solid 70% of the tops I've seen were caused by competition."

Another time to sell "no matter what" is when you see accounting irregularities, he added. An options-backdating problem, however, is not an accounting problem, Cramer said; it's a compensation problem.

"Companies that backdate options for their officers don't do it because business is bad, like companies that lie about their financials -- they do it because business is good," he said. "Those executives would rather take stock than cash," and, if anything, that's a reason to buy the stock, not sell it.

Another way to see a top coming "a mile away" is when the company starts over-expanding. Even though Cramer said he likes growth, sometimes an acquisition is a sign of overexpansion. "It's hard to execute these things properly, and if a company can't pull it off, your stock will end up peaking rather than going higher," he explained.

"The code for overexpansion on the Street is integration problems," Cramer said. "When you hear management say those two not-so-magic words, you know a top is coming ... and it's time to run for the exits."

Finally, the last sign of an impending top is government action, he said. The government, at the federal or the state level, can do more to hurt a company than any competitor.

To spot this kind of a top, Cramer advised people to check out the front pages of *The New York Times*, *The Wall Street Journal*, *USA Today* and *The Washington Post*. And "don't just stick to the business section, because it never pays enough attention to Washington," he said.

Also, spotting a sector rotation, "when money moves from one sector or group of sectors into another because of the business cycle, is of the utmost importance" if you want to make money in the market, Cramer added.

There are two kinds of companies: cyclical businesses, which tend to do well when the economy is growing fast and not so well when the economy is slowing down, and secular stocks, which tend not to be sensitive to the underlying strength or weakness of the economy, he said.

At the top of the cycle, before you think a downturn is coming, it's good to load up on your secular stocks. At the bottom, it's better to swap out of all of that for some "beaten up" cyclicals, Cramer said.

Now, the "holy grail" of Wall Street is "figuring out when and how a company's earnings are going to change before anybody else does," he said. "It's hard to do, and it is time consuming, but, man, does it pay off."

There are two ways to spot changes in earnings, Cramer said. One way is to "start from the bottom." For example, with retail, people can go to stores, watch the register and count the transactions.

"You've got to do this at more than one store and at more than one time," he said. "When something is flying off the shelves at a pace that isn't reflected by the earnings estimates, buy the stock of whoever makes it."

However, in the case that investors don't have the time to do that kind of homework, they can try to anticipate spending cycles, Cramer said.

For example, "the airlines have an incredibly predictable spending cycle," he said. "When you see that **Boeing** is getting a lot of orders, you need to buy the stocks of Boeing's suppliers, the **Fairchild**, the **BE Aerospace**, the **Honeywell**. As soon as the analysts start loving these stocks, you get out."

"You watch the indicators, you stay disciplined, the rest of the market will follow you; and that's the situation you want to be in," Cramer said. "The lead dog might feel lonely, but he's got the best view."