

SPECIAL TRADING REPORT

**ETF Trading Tactics, Part II:
How To Use RSI To
Trade Index Funds**

By

Loren Fleckenstein



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Index shares, exchange-traded funds that track stock indexes, form a relatively new class of security. But as fund traders, we can borrow time-tested tactics used by futures pros who have traded off the same indexes for years.

A case in point is the **Relative Strength Index**. Futures traders have used the **RSI** to detect overbought and oversold levels in the S&P 500 (\$SPX.X) and Nasdaq 100 (\$NDX.X) stock indexes as well as a wide variety of other markets.

In this lesson, I'll teach you how to use the RSI to time buys of the Standard & Poor's Depository Receipts (SPY) and the Nasdaq 100 Tracking Stock (QQQ). These exchange-traded funds, commonly called **Spiders** and **Cubes**, track the S&P 500 and Nasdaq 100, respectively.

About the RSI

The RSI is a momentum oscillator developed by J. Welles Wilder Jr. and first publicized in 1978. It measures day-to-day up and down closes in an index or security over a given period.

The oscillator's readings range from 0 to 100. Extreme low readings indicate an oversold condition. Extreme high readings flag an overbought condition. The system discussed in this tutorial uses RSI only as an entry signal. So we will concern ourselves only with oversold levels.

Don't confuse RSI with **relative strength**. The RSI measures an index or security's performance against itself. Relative strength compares a security's performance to an external benchmark, such as a stock index or a set of other individual securities.

Using the RSI to Trade Index Shares

When an index or security enters a strong trend, it will stay in overbought or oversold territory on the RSI for a long time. Just buying or selling index shares when their underlying stock index hits oscillator extremes will land you in the poor house.

For instance, if you bought and held Spiders whenever the RSI flashed oversold, you eventually would end up riding a correction or bear market right into the tank! So if you use the RSI, you need additional signals identify possible market turns.

I'm going to show you a way to use the Relative Strength Index [in](#)

combination with other variables to spot bottom reversals on the S&P 500 and Nasdaq 100. In a nutshell, we want to see the RSI enter an oversold condition, then re-emerge to the upside. Meanwhile, the stock index itself must confirm the rally by trading above a long-term moving average.

This bottom reversal signal was introduced to me by Jay Kaepfel, director of research at Wheaton, Ill.-based Essex Trading Co., and author of two primers on options and futures trading: [The Four Biggest Mistakes in Futures Trading](#) and [The Four Biggest Mistakes in Option Trading](#) (Traders Library).

Kaepfel uses this tactic to trade options on the OEX, but he has found that the same approach works well for trading the Spiders and Cubes.

The system has a good record of alerting traders to intermediate-term rallies. But of course, not every signal will lead to a rally. Some upturns will fail.

You must combine any trading system with money-management controls -- chiefly, position sizing and protective stops -- to safeguard your account from severe losses and to take profits. You'll also rely on your own trailing stops or sell rules to furnish your exit strategy, as we'll be using the RSI signal solely as an entry mechanism for exchange-traded funds.

Configuring Your Charting Software

We will watch stock index itself for signals, rather than the trading action of the exchange-traded fund that you plan to trade.

To use this system, you'll need charting software that includes the RSI and moving averages and allows you to configure those indicators at will.

Set the RSI's oversold boundary (buy zone) at **40** and the length to **14** days. If your software makes you to enter an overbought boundary (sell zone), choose an arbitrary number above 40. It's of no importance because, as I said, this is strictly an entry mechanism. I selected 70. Also set a **250-day** simple moving average on the targeted stock index.

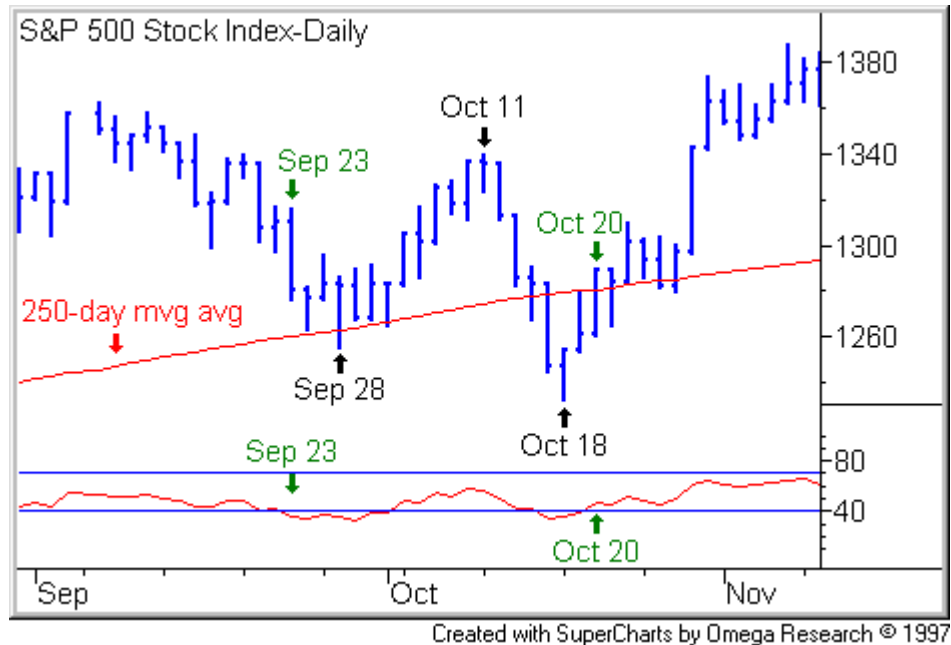
Entry Rules

1. The stock index falls, sending its RSI below 40, but the stock index still closes above its 250-day moving average. This alerts you to potential bottoming action.
2. Next, the stock index rallies, then declines again. In this decline, the stock index can hold above the prior low or make a new low. It can remain above the 250-day moving average or cross below it. But the RSI must drop below 40.
3. Buy if the stock index rallies far enough to lift the RSI above 40 and the stock index stands above its 250-day moving average.

S&P 500 and Spiders

Let's look at an example of how you would buy S&P 500 Depository Receipts

(SPY), using the RSI of the S&P 500 (\$SPX.X).



On Sept. 23, 1999, the S&P 500 fell 29.75 points to 1280.75. The 14-day RSI slipped to 34.99 from a reading of 42.07 in the prior session. The index was trading above the 250-day moving average.

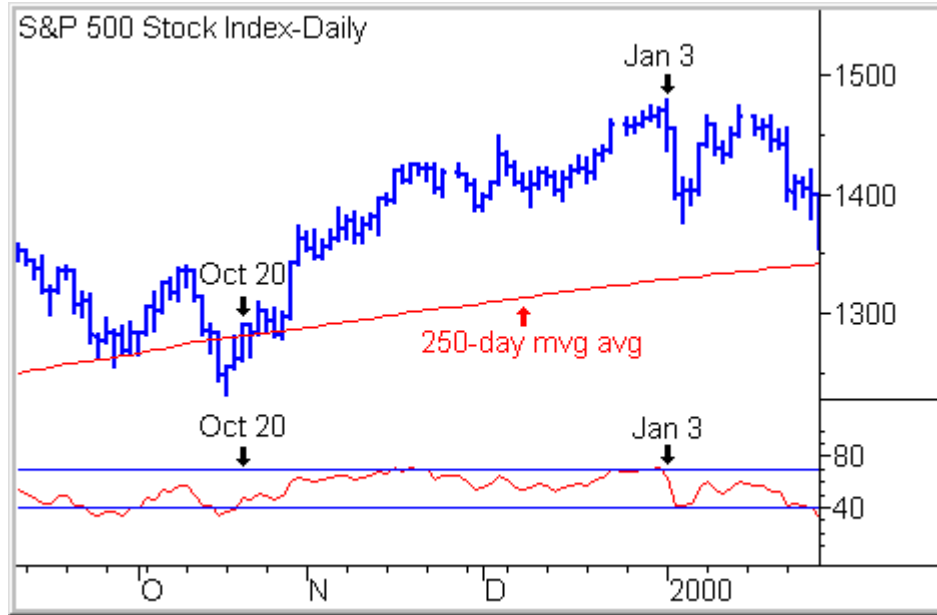
That satisfied Rule 1. You got your wakeup call! Now you want the index to rally and fail.

The index obliged. After marking a session low of 1256.30 on Sept. 28, the S&P climbed to a session high of 1339.25 on Oct. 11. The RSI climbed back above 40. Then the stock index rolled over, making a new intraday low of 1233.65 on Oct. 18. The RSI slid below 40 in the prior session. Rule 2 is met.

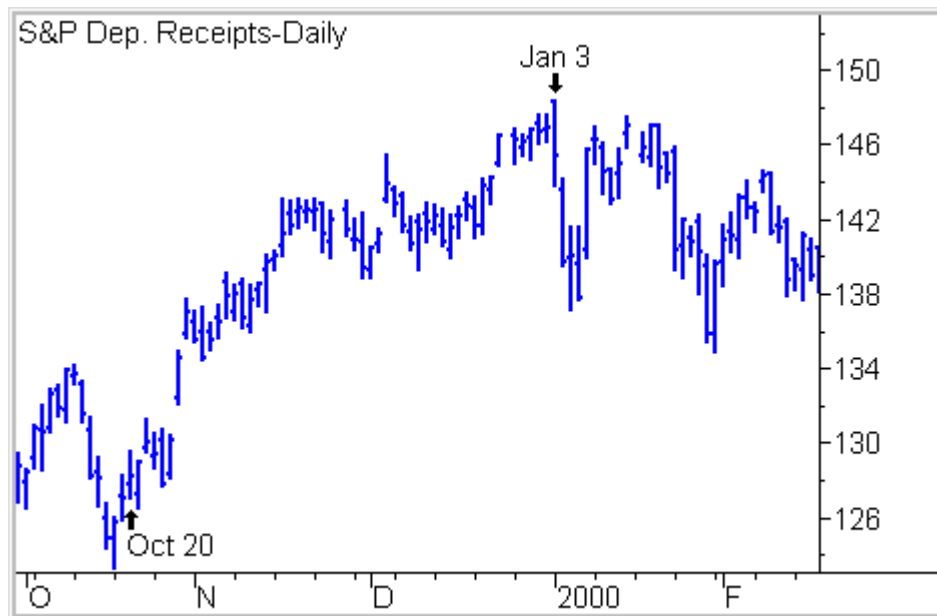
Now the hammer is cocked. It remains for the index to rally sufficiently to pull the trigger. That means the index must advance far enough to overcome its 250-day moving average and lift the RSI back above 40.

The S&P rallied off the Oct. 18 low. It closed up to 1289.45 on Oct. 20, clearing both bogeys on the RSI and moving average. Check off Rule 3. At this point, you would have gone long the Spiders, establishing your initial and trailing stops and position size in accordance with your money management regime.

Here are longer-term views of the subsequent market action in index and Spiders from the same setup and entry.



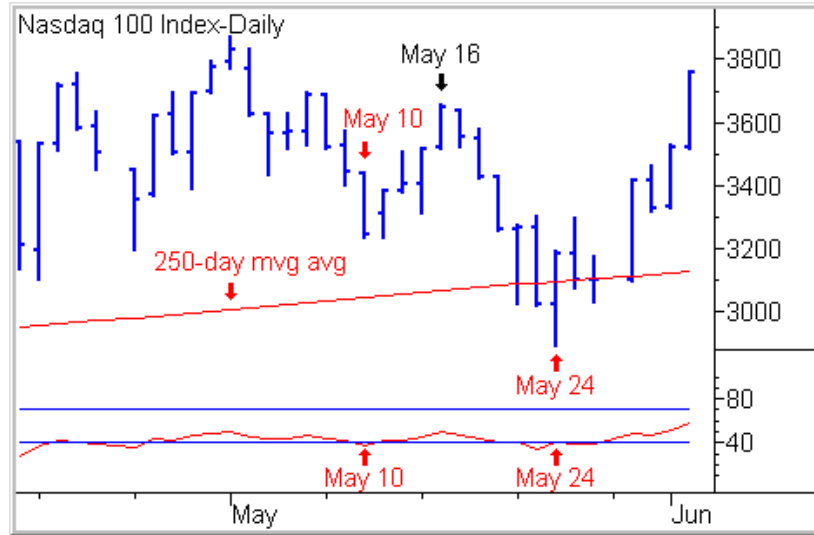
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Nasdaq 100 and Cubes

The Nasdaq 100 (\$NDX.X), which tracks the 100 largest-cap non-financial stocks traded on the Nasdaq, flashed a buy signal on May 24, 2000. At that point, you would have gone long the Nasdaq 100 Tracking Stock (QQQ).

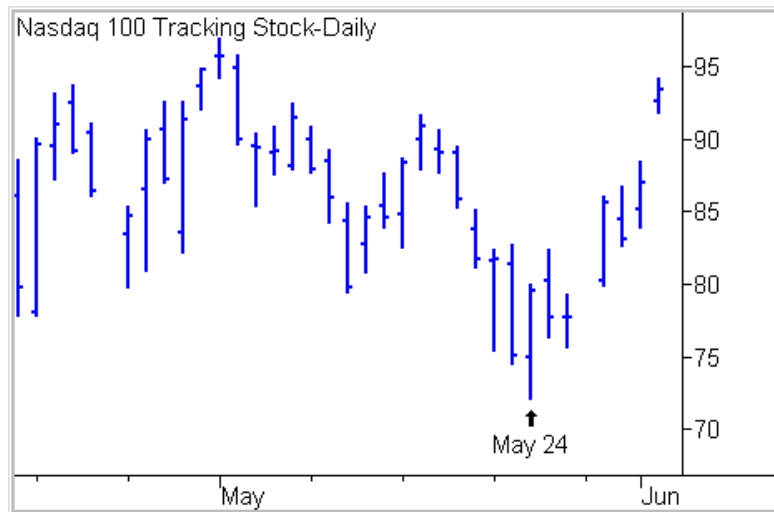


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As you can see from the chart, the stock index dropped 200 points to 3245 on May 10, decreasing the RSI to 37.04 from a reading of 41.34 in the previous session. At the time, the index remained above its 250-day moving average.

The stock index subsequently rallied to a May 16 peak, then headed south, carrying the RSI back below 40. The stock index made a new low on May 24, then rebounded the same day, clearing its 250-day. The oscillator registered 40.15, just barely in the buy zone but enough to flash your buy signal.

Here's a chart of the Cubes over the same time frame.



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Part 2 in a series of three. Also see Part 1: Identify ETF Turns Using Moving Average Crossovers, and Part 3: How to Short ETF Breakout Failures.