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Stocks' 200-day moving average can signal sell and buy

Q: Is it true you can make money in stocks and avoid losses if you buy when markets are above their 200-day moving average and sell if they fall below?

A: There are many adages on Wall Street. Some claim you can pick the best time to buy stocks based on which team wins the Super Bowl, the length of women's hemlines or even astrology.

Academics have proved such events that seem to predict market moves are due to chance. And research has shown that even events that do tend to predict stock market moves lose their predictive power as more investors catch on.

But there's one indicator that seems to defy being debunked: the 200-day moving average. The indicator's allure is partly its simplicity. The 200-day moving average is calculated by taking the stock market's price the past 200 days and deriving a simple average. The 200-day moving average changes each trading day, as the oldest data point falls off and is replaced by that day's closing price.

The 200-day moving average is a widely available statistic. You can get itany time at money.usatoday.com for both stocks and stock indexes. For instance, you can get the 200-day moving average for the Standard & Poor's 500 index by putting SPX in the Get a Quote box and then choosing the Charts function. Under Moving Average choose SMA and put 200 in the box to the right.

Using the average is simple. The rule says if stocks fall below the 200-day moving average, you want to sell. Conversely, if stocks rise above their 200-day moving average you want to buy.

I know. This seems like yet another strange way to try to time the market. But it has worked, according to historical trading data from Ken Winans of Winans International. Investors who followed the 200-day moving average rule enjoyed larger returns than those who bought and held on between 1988 through fall 2008.

This year, the S&P 500 stock index rose above and stayed above its 200-day moving average in July. While investors using the rule missed the bottom, set in March, they were still in early enough to enjoy a big portion of the upside. These investors, it's important to point out, also missed a lot of the bear market that began in 2007 if they followed the average and sold early in 2008.

But with all such timing tools, a big dose of caution is justified. For one thing, stocks have a tendency to flirt with the 200-day moving average. You might find yourself getting whipped around trying to follow the rule. For instance, the S&P 500 climbed above its 200-day moving average June 1, but slipped below again June 22.

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And remember, you're not the first person to discover the 200-day moving average. If it truly does work, other investors may pile on and reduce your potential gains.

The 200-day moving average is certainly worth watching. But it might be dangerous to make this single measure the basis for your portfolio.

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