Moving Averages – What they are, and what they'll tell you

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A moving average (MA) is to a trader as a hammer is to a builder, a pencil is to an artist, a hook is to a….well, you get the picture. If you're a budding trading looking to make money from home, using MAs will be one of your best friends! Traders of all sorts use MAs – from the amateur trader just looking to make some extra money to the Wall Street professional trading millions of dollars in a single trade. Here's how it works.

Let's say you're looking at the price of a stock over the last 5 minutes. It's a live chart, continuously moving forward as time marches on. The price started at $5, hit $6 a minute later, then $7, $8, $9, and then finally $10 in at the 5th minute, which is where you're now looking. That means that as the price hit $10, the 5 minute MA of the asset was $8. If the price continues to rise, the MA will follow it up.

If the price of the asset starts to fall, traders will wait to see if it falls below the MA. In this case, if the price falls below the $8 MA, it's a sign that price momentum may have shifted, and the price is in for an even further fall. This bearish sign will cause a trader to consider purchasing a put option on the asset and make money as the price continues its fall down. At some point, the price may start to rise again, cross the MA on the way up, and that same trader will consider closing out their put and buying a call to make money on the way back up. It's exhilarating to trade trends up and down and see your bank account swell!

Types of Moving Averages

Single Moving Average

A single moving average (SMA) is one line that follows price on a chart. Short averages will average the price of an asset over the last few seconds – longer SMAs will give the average price over the past several days/weeks/months. If you're looking at a chart and see one, continuous line following the price of the asset up and down, odds are you're looking at an SMA.

Double Moving Average

The double moving average (DMA) is a lot like the single, except there are two lines on the chart, not just one. Each line is still a moving average, it's just that one is shorter-term and one is longer-term. If you're looking at a chart showing movement over the last 10 minutes, you could most likely have one line keeping track of the average price over the last 300 seconds, and one over the last 60 seconds. The lines will dance and cross each other as the price of the asset moves up and down.

Traders prize a DMA because it gives an additional sign over the SMA. With the single, remember, we have to wait until the price crosses the MA on the chart before we can say an "event" has taken place. With the double line, the short-term MA will cross the long-term MA BEFORE the price will cross either, giving the trader valuable seconds to decide whether or not to place a trade.

Linear vs. Exponential

You'll also hear about simple moving averages (SMA) vs exponential moving averages (EMA). They do the same thing, and even look the same. The difference is that the SMA uses the pure price average, where the EMA uses some more complex math. The potential problem with the SMA is that, sometimes, the SMA can be a little erratic and extreme when following the price of a volatile asset. If the SMA spikes too sharply, it'll cross the price giving a false event. To solve this, a man named Patrick Mulloy decided to make the math more complex in order to smooth out the line. The smoother line gives fewer false indications, but can sometimes show signs seconds later than an SMA.

The Bottom Line

The bottom line is that there are many, many types of MAs. In the end, they all work on the above principles, and no one is better than the other. They all tell the same story, in just a slightly different way. It's like hearing the same story told to you by someone from Boston vs Tennessee vs England – they'll all tell you the same thing, just with a different accent. Most trading platforms will have a dozen MAs to choose from.

To get a feel for MAs, you can paper trade (trading in a "pretend account" in a live market) until you find one you like. OR, feel free to stop by the Trading Floor and see Slicktrade's professional traders as they use MAs, along with other technical indicators, to make trade calls. It's almost as fun to watch as it is to trade yourself…almost!

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