

Bestselling Author of *The Master Swing Trader*



THE Master
Swing
Trader
Toolkit

The Market Survival Guide

ALAN S. FARLEY

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ALAN S. FARLEY



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For Donna
Wife, Mother, and Truth Serum

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F O R E W O R D

Alan Farley is well known as the author of *The Master Swing Trader*, for his insightful columns at TheStreet.com, and for his many contributions to the trading education community. His Web site, HardRightEdge.com, is an Internet pioneer, providing a virtual wealth of trading information, education, and analysis. Over a decade after its creation, that portal remains a valuable reference tool for industry professionals and beginning traders alike.

Like most individuals, I first saw Alan at trade expos during the tech bubble era and on television, as a frequent contributor to CNBC. We were finally introduced in 2000 at a small seminar in Arizona and became friends three years later when he participated with me in a large trading conference in Scottsdale.

Alan and I continued to work together in the intervening years, both as business partners and as trading educators. I've had many opportunities to observe him firsthand during this time, both as teacher and trader, and can't help but admire his keen insight on price behavior and near-fanatical obsession with controlling risk. These are attributes that have enabled Alan to survive and prosper while others in the trading community have been decimated by unprecedented volatility and market turmoil. So, while you likely know Alan Farley as an accomplished author, I've come to know him as a master technician, an elite trader, and a close friend.

Traders and investors are now rethinking their approach to the financial markets in response to the 2008 market crash. Notably, the past decade has left "buy and hold" investors out in the cold, whereas "swing traders" like Alan have excelled. Since the crowd historically gets it wrong, there's never been a better time to look at, and to master, the market strategies that Alan has been teaching for over a decade.

His latest offering is destined to take its place alongside other classic trading books, including his first volume, and should be an invaluable reference for every serious-minded trader. I've reserved a place for this eagerly awaited sequel in my collection.

Kerry Szymanski
Harmonic Edge
www.HarmonicEdge.com

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P R E F A C E

A few interesting things have happened since I wrote *The Master Swing Trader* in 2000. Let's see. There was a terrorist attack on lower Manhattan; two bear markets; a credit meltdown; burst bubbles in tech, real estate, and energy; the pattern day trading rule; Regulation NMS; the end of the market-making system; decimalization; Martha Stewart; Bernie Madoff; dark pools; China; trading bots; and, last but not least, Jim Cramer.

Through it all, traders have been forced to adapt to, adjust to, and accommodate the near-apocalyptic changes, hoping their strategies would endure the shifting tide of system shocks, rule changes, and electronic obstacles thrown onto their paths to profitability. Sadly, this decadelong revolution from a human-driven to an electronic market environment has taken a severe toll, with the vast majority of the trading community washing out and moving on to safer hobbies.

To be frank, I'm astonished at just how well the concepts outlined in *The Master Swing Trader* have held up in the last decade. Of course, I knew the techniques espoused in that book had tremendous value because it's the way I've been trading the financial markets since the late 1980s. But I didn't realize how the core principles, such as the trend-range axis, pattern cycles, and cross-verification, would give me exceptional tools to decipher the Mad Max landscape and to adjust my "game" to match the day-to-day madness that now defines our modern market.

Technical analysis has been battered and beaten in the last decade by software programs that have deconstructed every trendline, moving average, and candlestick. But, amazingly, a new inefficiency door opens wide every time the trading bots find a way to undermine a technical system, pattern, or workflow that's putting food on our tables. This game of Whack-a-Mole makes things relatively simple, yet infuriating, for the serious-minded trader who wants to earn a living in the markets. Simply stated, we're forced to play our game in the school of "what works now."

The Master Swing Trader focused on the trader's role in managing concepts and strategies based on classic market principles. That mindset carries through into this book without too many comprehension issues for readers unfamiliar with the first volume. However, this book isn't a rehashing of the first one, nor does it itemize a thousand new patterns and

indicators. To be truthful, I've headed down a simpler path in recent years, using fewer indicators and more common sense to trade the markets.

By necessity, this text reintroduces a number of principles from the first book to keep new readers on track. In addition, you'll note frequent references if you want to keep the first book close at hand while reading this one. Beyond that, any intermediate trader should be able to pick it up and understand what I'm talking about, with few speed bumps. You'll also note the text in this book is far less obtuse than in the original. That shift in style comes from meeting a decade's worth of writing deadlines for those fantastic folks at TheStreet.com.

The Master Swing Trader Toolkit: The Market Survival Guide covers two primary themes:

- It expands on ideas in the first book. It's a decade later and my working strategies have grown well beyond the topics covered in that kinder, gentler era. It also presents material that was omitted or compressed the first time around, with extensive discussions on risk management, market exposure, and, most importantly, tape reading.
- It identifies defensive strategies that work specifically in the modern electronic markets. The emphasis here is on the word "defensive." As far as I'm concerned, any strategy that fails to address the extreme risk posed by the trading bots is doomed to failure. In this regard, you'll find a major focus on program algorithms and their huge influence on the index futures and exchange-traded funds.

While the first volume was concept oriented, this book is far more application oriented. That's why I've included a case study section called "The Real World" at the end of each major part. One criticism of the first book was that I didn't include enough examples showing how the patterns and observations applied to specific market scenarios. This book addresses that omission as a major focus.

I've also progressed significantly as a trader in the last 10 years. As a result, there are many elements in my current market strategies that are brand new for this decade, even though the core principles remain the same. I believe this evolutionary shift in thought and action will provide great insight for the intensely loyal community that enjoyed the first book and wants to understand how to apply the concepts in the current environment.

Although I've written this book in the aftermath of the 2008 credit meltdown, I fully realize the world markets will change and change again in the next 5 to 10 years, and I don't want this material to become outdated. For this reason, some generalization has been required to keep the ideas and strategies relevant beyond the aftershocks that have followed this painfully historic era.

The first part of *The Master Swing Trader Toolkit: The Market Survival Guide* itemizes the significant changes to market structure that have taken place in the last decade. It redefines the elusive trading edge and how it's best applied in our modern electronic environment. It also introduces the *survivalist trader*, which you'll find is a core concept throughout this text.

Part Two revisits the market clock with a detailed look at intraday, daily, weekly, and monthly cycles. It offers working strategies for earnings season, options expiration, Fed days, window dressing, and the host of time-sensitive events that define the market calendar. Frankly, I don't know how anyone can trade these days without a thorough understanding of market seasonality and its overriding impact on the ticker tape.

This part also reintroduces the concept of relative strength and weakness. Seriously, I've become an absolute fanatic about strength-weakness cycles in recent years and how they enhance my trade execution and management. Force me to toss out my toolkit of indicators and use just a single one on all my charts, and I'll pick the 5-3-3 Stochastics every time.

Parts Three and Six are joined at the hip, with the third part focusing on the nature of winning. This part begins with a general discussion of long- and short-term profitability, followed by the detailed strategies needed to achieve those goals. Meanwhile, the sixth part looks squarely at the nature of losing, drawdowns, and self-sabotage. This random walk on the dark side leads naturally into a checklist of risk management and trade collaring techniques that are designed to keep us "in the game."

The third part also introduces my near obsession with convergence-divergence relationships. I still recall listening to an old tape of Linda Bradford Raschke in which she states that every two points of market data and tone create a valid convergence-divergence relationship. I've taken that observation to heart over the years, with this deceptively simple concept now providing the fundamental core of my trading and market analysis.

Part Four takes a close look at world markets, trading accounts, and capital allocation. My first book completely missed the boat on these subjects, and I'm finally making amends. I know it's natural to just stare at

the price charts and play the numbers, but our long-term survival depends on the broad variety of structural decisions outside the real-time ticker tape. This part will make that chore far less daunting.

The fifth part, covering pre- and postmarket strategies as well as the quirky playing field known as “the intraday markets,” should be extremely useful for the fast-fingered crowd and other market-obsessed entities. Of course, I put myself in that frantic category. This is the place you’ll find the trading strategies you need to play gaps, news shocks, traps, midday noise, and volatility.

You’ll discover a little secret when reading through this part. In a nutshell, this is actually a book about tape reading rather than technical analysis. That’s an intentional focus because, no matter how much the markets change, the ticker tape is the one thing in our peculiar universe that cannot be manipulated, deconstructed, regulated, or fragmented. As a result, it remains the most powerful tool in our battle for the bottom line.

I hope you enjoy my second book and learn something new and profitable in each chapter. And, yes, it’s true that I’m a relatively easy person to contact, if you have questions about the material. Frankly, I’ve found this openness has been an easy chore to manage over the years, so feel free to get in touch.

A C K N O W L E D G M E N T S

I have many folks to thank for helping me to write this follow-up to *The Master Swing Trader* and for their loyal support over the years.

At the top of my list, a huge thanks to TheStreet.com for giving me a soapbox to communicate my market views and technical approach for the last decade. In a twist of fate, that door opened just three days after the September 11 attacks, when I was asked to write a swing trading newsletter and column. Talk about mixed emotions! Many great folks have passed through that portal over the years. I particularly want to thank George Moriarty, Michelle Donley, Gretchen Lembach, David Morrow, Eric Harding, Dan Fitzpatrick, Helene Meisler, Harry Schiller, and, last but not least, Jim Cramer.

The translation of my first book into many languages has opened the door to world travel. The amazing folks at the other end of the long plane ride hold a special place in my heart: André Malpel, Valerie Cornelius, and their beautiful family; Davin and Jackie Clarke; Peter Mohorcic; Jean R. Soublière; Jack Lee; Patrick Stokowski; Clive Corcoran; Patrik Christerson; and Eva Diaz.

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Finally, thanks to Mina Delgado and eSignal for a great relationship over the years and for allowing me to use their charts in this book.

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ONE

PART

PARSING THE MODERN MARKETS

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1

C H A P T E R

PROSPERING IN THE POSTCRASH ENVIRONMENT

The markets have never been a pretty place. Just ask those Dutch traders who bought into the tulip mania back in the seventeenth century. You think the real estate bubble was bad? Imagine paying the modern day equivalent of \$10,000 for a single tulip bulb, sight unseen. Where were the attorneys general and the SEC enforcers back then, when they were really needed?

To be frank, I like my markets just the way they are, warts and all. And I'm convinced that world capitalism would get a lot worse if we didn't have a good place to make bad decisions, at least between 9:30 a.m. and 4:00 p.m. New York time. Maybe that's why I cringe whenever government bureaucrats or state prosecutors step onto our sacred ground.

You see, we earn a living when other people put on their dumb hats and buy too high or sell too low. No, folks like us don't build bridges, sell suits, or lead their flocks to salvation. To be realistic, we contribute absolutely nothing to society except pure liquidity and an aggressive attitude. And you know what? I wouldn't have it any other way, because the trading

game works directly with the machine language of the world monetary system and is the only profession I know that doesn't depend on a boss, a company, or an economy. At its core, our unique business feeds ruthlessly off the excesses of the marketplace, and it just wouldn't be the same without all the manipulation, misinformation, and monkey business.

Many former investors now hate the financial markets and anyone who prospers through trading or speculation. With biblical fervor, these folks believe that justice must rain down on the greedy bastards who still appreciate the marketplace or prosper from its existence. Amazingly, many of these self-righteous critics still follow the market's every twist and turn through their favorite news channel or Web portal. Talk about hypocrisy!

I have a standard response whenever I get attacked for my continued faith in trading, capitalism, and the modern markets. It goes something like this: Why waste your time if you're getting angry and upset reading the financial news? Take up knitting instead, or, better yet, join a political party. I'm sure you'll be much happier in your misery, and Mr. Market will be a much kinder gentleman without your daily attendance.

To quote a famous fictional trader, greed is good. Greed pays the bills and gets the kids through college. Greed also performs an important community service. It relieves the misinformed of their excess capital and gives it to those more deserving of its ownership. Indeed, pure unadulterated greed greases the engine of worldwide market inefficiency. And, without question, the twenty-first-century trader must be greedy in order to develop the predatory style required to prosper in our modern electronic markets. This fact of life may be distasteful to folks who still believe in the tooth fairy or in Robin Hood, but the rest of us understand there will be a loser for every winner, and everyone who plays the financial markets has to choose whether to take—or get taken.

THE PARADOX

The next two declarations are true on multiple levels, but they're also totally contradictory. The markets (a) are the same now as they were one hundred years ago, with timeless principles moving the tape, and (b) have changed radically in the last decade and no longer operate according to timeless principles. Therein lies the challenge for traders at all levels as we head into the second decade of the new millennium. In a nutshell,

we've read all the technical analysis books, attended all the seminars, and listened to all the market gurus and talking heads. But nothing, absolutely nothing, has prepared us for the surreal science fiction landscape we're now forced to navigate each day.

Of course, it starts with the trading bots. We knew the influence of program trading would grow when we saw its handiwork between 3 and 4 p.m. New York time back in the 1990s. But who could have predicted that coldhearted algorithms would become the overriding force in price development, on a daily basis, just 10 years later. On the surface, computerized trading is a great addition to the marketplace because it adds significant liquidity to the ticker tape. But these algorithms lack the singular force of nature we could always count on throughout our years of flipping stocks, futures, and currencies: they operate without the twin emotions of greed or fear.

That's right, trading bots won't panic when they find themselves on the wrong side of the market and won't get euphoric after good news delivers a windfall profit. In other words, they don't act or react to the financial markets like you or I, our neighbors, or those suits on Wall Street. They're cold, calculating, and totally focused on their one-minded goal to move the markets in their favor. Sadly, today's state-of-the-art algorithms wouldn't work with such diabolical precision if the market's historic center of gravity still existed. For all our complaints in the 1990s about the NYSE specialists and Nasdaq market makers, those savvy middlemen kept the trading bots in a controlled space, from which we flesh-and-blood players could coexist in an uneasy peace.

That delicate balance was lost, perhaps forever, when electronic execution systems killed the middlemen around 2005 and replaced their overriding role in maintaining orderly markets with the ephemeral barrage of bid-ask prices that now flash across our screens at the speed of light. Retail traders like you and me have been forced to operate since that time in a desolate Mad Max landscape that has become the centerpiece of our twenty-first-century auction place.

Wait a second. If things are really *that* out of control, why don't we all just give up and find another moneymaking hobby, like poker or macramé? Well, as it turns out, you can only screw around so much with the modern market environment before it bites back. Whenever the tape gets a little too crazy, manipulated, or downright synthetic, we can depend on the natural forces of supply and demand to suddenly kick back into gear and take control, just like the old-fashioned NYSE circuit

breakers. Therein lies the incredible power of technical analysis. In truth, this venerable practice still works, although it's been battered, beaten, and deconstructed into a zillion microscopic particles. Indeed, the power of price charts to expose zones of conflict and levels of opportunity is undiminished in our new millennium, despite trading bots, inadequate regulation, and a marketplace with no center of gravity.

The balancing act for modern traders like you and me is to coexist peacefully with the market whales that control price movement while applying technical analysis and razor sharp observation to identify inefficiencies that translate into consistent profits. Of course, this is easier said than done because long-term profitability requires a near fanatical commitment to our unique craft. Gone are the salad days when we could just throw money at a rising tape and expect to get paid off on a regular basis. Simply stated, there's no seat at the table for lazy or dumb money in our tough-crowd, postcrash market environment.

If you're still up for the considerable task, despite the sea of obstacles, you'll need to master the three overriding aspects of market knowledge and day-to-day strategy. These essential items represent the core themes of my peculiar market view:

- Recognize what the market is saying whether or not it supports your bias or positions.
- Find the right time and right price to take on exposure, or step back to the sidelines.
- Manage risk with razorlike efficiency while adjusting the odds in real time at the hard right edge.

Finally, let me offer a word or two about trading discipline. As I noted ad nauseam in *The Master Swing Trader*, most market players will fail due to a lack of discipline rather than a lack of knowledge. Despite that great truth, most of us are uncomfortable with the subject matter because we've deluded ourselves into thinking we're disciplined individuals when we're not. Simply stated, the strategies and observations in this book are totally worthless if you fail to exercise steady discipline in your market approach. And there isn't much I can say or do to turn you into a more disciplined trader. So, beyond a pleasant set of truisms, bulleted lists, and horrifying examples scattered throughout this text, you're on your own when it comes to this life-or-death aspect of market performance.

THE DIABOLICAL MARKET

Listen up, because the next sentence is extremely important to your long-term survival. *Traps and trapping behavior are the primary forces moving our modern electronic markets.* This contrary dynamic assumes the tape will act in a way that hurts the most traders and trading strategies. While still dangerous, these bull and bear traps occur less frequently when the public floods into or out of the market, especially during strong bull advances and cascading selloffs.

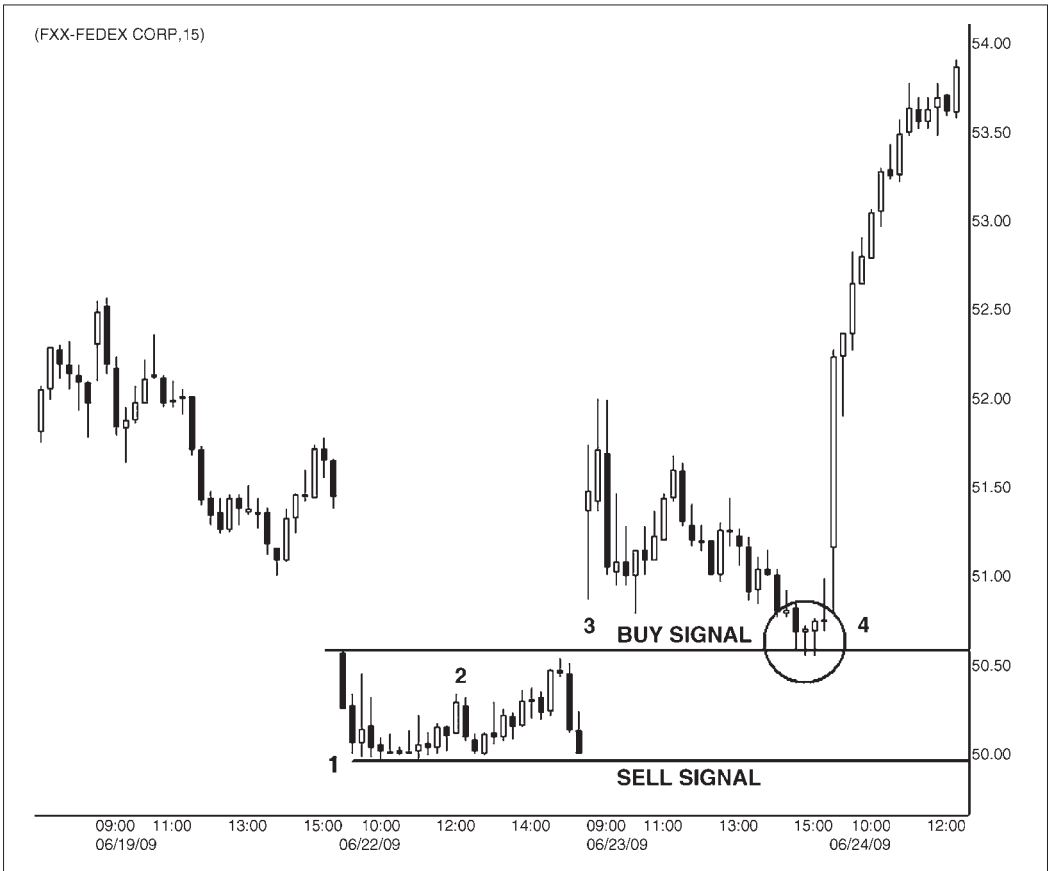
Price seeks volume at all times and will go to great lengths to find it. This is why the markets tend to move toward points of maximum pain, taking out carefully placed stop losses and rational risk-based positions. In other words, the majority needs to be punished, with this prime directive seeking out fulfillment through diabolical price mechanics. This force of nature becomes especially powerful after events (economic news, Fed meetings, earnings reports) that defy current expectations. Sadly, most traders react to shock data by overthinking the news instead of just leaning against whichever side of the market is getting trapped as event-driven price swings oscillate through the ticker tape.

How does price *know* where the greatest pain lies? It's relatively easy, because most traders do things in exactly the same way. For example, the majority of the retail crowd chases into overmargined positions using momentum strategies already deconstructed by the smart money and their emotionless machines. As a result, price action undermines those classic methodologies far more efficiently now than in the past. Fortunately, traders have the power to co-opt this contrary force and use diabolical thinking to get on the right side of the market. Simply stated, diabolical thinking is your razor sharp focus on all the traps that can be set against the majority. To this end, ask yourself the following question whenever a shock event hits the market: "Which side has the biggest targets on their backs, *right at this minute?*" If you can answer that query accurately, you're in a great position to make money. Figure 1.1 provides an example of how this diabolical thinking works in real-time.

FedEx gaps down on June 22 in response to a premarket shock event. Downside momentum fizzles out within the first 45 minutes (1) of the session, with the stock settling into a narrow trading range (2) through the rest of the day. Clearly, longs holding positions overnight are the first group to be trapped by the big gap. But the bull-bear dynamic

FIGURE 1.1

FedEx Gap



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evolves over time because weak-handed short sellers pour in at the open “just because” the stock is down over a point. In the real world, these folks need to get punished because the lazy trade rarely gets rewarded. With this in mind, the observant trader recognizes that two conflicting groups have targets on their backs that morning. First, the downside has to go far enough to shake out trapped longs. Second, the downside also needs to deny short sellers who jump in mindlessly after the open.

This bilateral scenario responds well to a first hour breakout-breakdown strategy in which the trader marks out the high and low for

the first 60 minutes of the session and then does nothing until one side gives way. Now, add in diabolical thinking and realize how the odds shift over time against the short sellers because the trading range refuses to break to the downside. This simple tape reading observation, taken in conjunction with a basic execution strategy, contains all the elements needed to (a) get a reliable signal, long or short, and (b) locate and execute a trade with favorable reward:risk.

FedEx's first hour range holds through the rest of that session, with price dropping to the morning low in the final minutes and inviting short sellers to enter at the close in anticipation of a breakdown at the next day's opening bell. The diabolical tape then kicks into gear, right on schedule, with a gap (3) well above the closing price and prior day's range. This buying thrust serves two vital functions. First, it traps short sellers, and second, it denies risk-conscious longs an easy entry into the new uptrend. The gap also serves a third and more diabolical purpose. It generates enough disgust on both sides of the aisle to force most traders to give up and move on, just as best entry (4) is finally setting up. This triggers when price pulls back to range support, tags it perfectly, and then resumes the uptrend with a three-point buying spike.

This perfect moment illustrates a key inefficiency within the diabolical crazy quilt. Simply stated, the market will often give you exactly what you want if you read the contrary forces accurately and are willing to wait long enough for your ideal trade. That's easier said than done when you're suffering from the data overload of a typical trading day, so how do you actually profit with diabolical thinking? For starters, realize that many traps occur in volatile markets that are in the process of shifting balance between bulls and bears. Green bar-red bar alternation and contrary day-to-day gaps are the most reliable "tells" for these all-too-frequent transitional periods. Two defensive entry strategies work well in these actively diabolical conditions:

- Stand aside and watch the edges of support-resistance until the shakeout games are over. Then step into the trade.
- Keep stop losses tight and position size small, taking multiple entries until price action finally yields a favorable trend.

Diabolical forces are at work in quiet markets as well. Financial instruments can move through narrow ranges for weeks, shaking out traders through false breakouts and breakdowns. As with more volatile markets, the real trend usually arrives when the crowd is put to sleep

through narrow range bars or is stuck permanently on the sidelines, licking their wounds after too many losing positions. Notably, the contrary dynamics in these large-scale events are identical to the FedEx gap example but can take months to unfold, instead of hours.

Mr. Market draws pretty pictures all the time through sentiment and price action. It's our job to wait patiently for the inevitable ambush as soon as the majority believes the illusion and takes the bait. This diabolical thinking process might sound like a lot of work just to make a few bucks in the financial markets. Well, that's true up to a point. Fading strategies—i.e., execution that takes advantage of traps—requires a unique skill set but, realistically, it's often the only way to play if you want to trade in the big leagues.

There's an old expression that bulls and bears make money while pigs get slaughtered. If you take a passive approach to the modern electronic markets, you set yourself up to get pickpocketed on a daily basis. For this reason alone, it makes perfect sense to identify the weakest hands as quickly as possible and then get positioned with the smart money and their coldhearted machines.

TWENTY-FIRST-CENTURY INEFFICIENCIES

The ferocity of the 2008 market crash caught most traders and investors off guard. Not surprisingly, none of the classic technical analysis books told us what to do when the CBOE Market Volatility Index (VIX) spiked above 50 and then whipped violently for over two months. The damage incurred during that historic period was as much psychological as financial, because it became virtually impossible to trade overnight. The postcrash aftermath triggered a secondary shock because most traders had spent their entire careers playing in a fertile environment that generated new and exciting bubbles on a nearly annual basis. In turn, that beneficial cycle fostered a grand illusion that all price movement takes place within relatively narrow buying and selling boundaries. Of course, we now know that this isn't quite true.

Price action generates constant inefficiencies that traders capitalize upon to earn their daily profits. These aberrations occur in all time frames, from five-minute charts to monthly trends. All inefficiencies, regardless of their source, have one thing in common: they generate a counterforce that will, sooner or later, cause the profitable opportunity to implode and

disappear. Here's a classic example. The tech bubble in 1999 and 2000 generated so much excitement that folks with no market knowledge—i.e., “waitresses,” “shoeshine boys,” and “Joe six-pack”—felt compelled to buy stocks at higher and higher prices. This chasing behavior eventually drained the last supply of available buyers, triggering a massively overbought technical condition that closed the inefficiency. Smart money then recognized the new inefficiency and sold the highs aggressively, triggering a massive decline that forced first-in first-out weaker hands to exit the market for substantial losses.

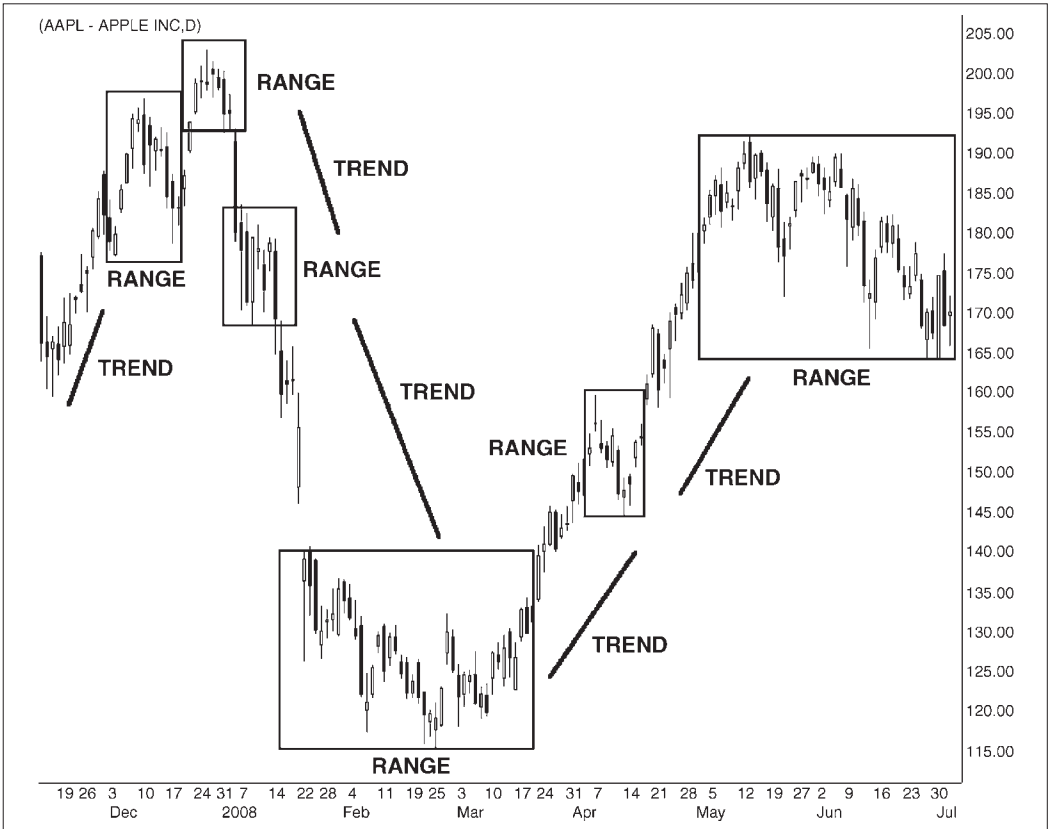
At its core, the 2008 crash simply targeted the buy-and-hold mentality, which, although Wall Street might disagree, was the most abused market inefficiency of the last two decades. We got hurt during that period to the degree we were mindless investors rather than trader-opportunists, and since most traders are closet investors, many of us got hurt badly. While the investing crowd can be forgiven for failing to comprehend the market dynamics that create profits, traders should be flogged for making the same error during those turbulent times.

The bottom line is, we have no choice but to play our game in the school of what works now. At a minimum, this overriding truth requires a diverse toolkit of strategies for trending, sideways, safe, and dangerous markets. In turn, this requires intimate familiarity with a wide range of tactics, holding periods, and risk management practices. Frankly, most traders, professional and amateur, are too lazy to do what's required to earn profits in a variety of markets, so the future belongs to those of us who carry the biggest and boldest bag of trading tricks.

There's a tendency in choppy markets to see meaningless swings as awakening trends and throw money at them. For obvious reasons, this impatience eats up capital and undermines our confidence. The only solution for this myopia is to step back and look at the big picture, identifying the exact placement of current price within the trend-range axis. This technical concept, a key element in *The Master Swing Trader*, refers to the oscillation of price between directional trends and sideways markets. These alternating states occur in all time frames, from one minute to monthly charts. There's also a proportional characteristic to this axis in which rangebound conditions persist about 80% of the time while trends occur about 20% of the time. Market efficiency aligns naturally with the trend-range axis. In other words, it isn't a good idea to chase a momentum trade in a sideways market or to fade a breakout in a fast-moving rally. Which brings us right back to the big picture. Simply stated, if you know exactly where you are on the trend-range axis, you can

FIGURE 1.2

The trend-range axis lies at the core of a successful swing trading strategy. All financial markets, including equities, futures, currencies, and fixed income, alternate between directional trends and nondirectional ranges in all time frames. Trading ranges persist for longer periods than uptrends or downtrends. Trading a trend strategy in a rangebound market, or a range strategy in a trending market, is a great way to lose money.



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usually find a strategy that takes advantage of that market stage and makes money.

Managing the elusive shape-shifter that we call “market inefficiency” requires mastering each of the variables in a well-developed trading plan. These include holding period, overnight exposure, fading protocols, time triggers and filters, stock segmentation, and position collaring. In sum, these are the main topics of discussion in the next eleven chapters of this book.

THE SURVIVALIST TRADER

You'll notice survival as a recurring theme as you go through this text. Dealing with the risk side of the equation in our modern market environment is far more urgent than chasing profits or unrealistically high returns. That's not to say the ticker tape won't offer low-hanging fruit from time to time. It's the *tweener* periods we need to address more carefully so that adverse price action doesn't pickpocket the capital we so carefully accumulate in more favorable times.

Here are five survivalist techniques you can employ whenever the market hits a rough patch or heads into a black hole:

- 1. Wait until the magic moment slaps you across the face.** Everyone is looking for the same thing in choppy or dangerous markets, i.e., a change in character that opens the door to a great buying opportunity or the most profitable short sale in decades. However, traders forget that cash is a position too. Here's a little exercise. Go back and count the money you would have saved in the last few years by sitting on your hands. I rest my case.
- 2. Remember that the charts still work.** Take a giant step back and examine the weekly or monthly charts when high volatility dulls your concentration and makes you question your strategies. You'll find that larger-scale patterns fit perfectly into support or resistance levels. In fact, if you look hard enough, they'll also tell you how long you need to wait before getting aggressive once again.
- 3. Become a big game hunter.** Clear your head and stalk your patterns for days or weeks, if required, rather than chasing the market around like a crazed monkey. Learn to keep your cool after missing a big turn. Just get up, pet the dog, and wait for the next trading opportunity to come along. It *always* does.
- 4. Embrace uncertainty and volatility.** Trading isn't about knowing what's going to happen next. It's about taking risk when the odds are in your favor. Just be happy when the market starts to move, even if it's against your position, because volatility shakes things up and creates opportunities. In other words, it's a whole new game of pick-up-sticks whenever prices jump from one level to another.
- 5. Survive first and the rest will follow.** Your first job in a tough market is to avoid losing money. Period. Listen to the calm inner voice that tells you what to do and what to avoid when a major

crisis hits the ticker tape. That's the voice of the survivor that wants to come out and play when the dark clouds finally pass.

The average retirement fund lost over 35% in 2008. One dark secret of the boom years, preceding the crash, was the outsized risk we took by clandestinely trading our IRAs, SEPs, and Keoghs. It's certain we'll be taking fewer leaps of faith with these cash accounts in future years because we're now far wiser and a lot closer to old age. In turn, this seismic shift puts more pressure on the performance in our margin accounts. It's hard to generalize about these speculative cash pools because a minority of traders reaped windfall profits playing the short side during the historic downturn. These folks have put themselves into a better position to act aggressively in future years because they have the firepower to assume greater risk.

Margin utilization and management takes on far greater significance in the postcrash environment. This is a two-edged sword because the assumption of inappropriate risk in unfavorable periods is a great way to wash out, while the underutilization of margin in favorable periods fails to maximize profits. As a general rule, traders need to cut down on margining until their equity curve confirms that they've successfully adapted to the intense demands of the modern markets. This is especially true for yo-yo traders, defined and discussed in Chapter 5, who alternate between big profits and big losses. For now, let's just say that margining is a big no-no for a yo-yo.

The survivalist trader needs to build a diverse toolbox that takes advantage of different market conditions and then become an astute observer and die-hard contrarian. Our primary task is to remain skeptical of every price swing, taking the time to read between the lines and figuring out what the market is really doing a few clicks before everyone else. Once that's accomplished, we back up our conclusions with a targeted strategy that fits the current ticker tape.

Reading the landscape better than our competition isn't an optional skill for the survivalist trader. At a minimum, it requires abandoning the illusion that all we need to win in the financial markets is a good technical analysis book and a few well-placed trendlines. In truth, every pattern has multiple outcomes, and we'll make little progress until we adapt the technicals to deal with the curveballs the market throws at us. Want to stay in the game for the next 5, 10, or 15 years? Start by leaving your opinion at the door and throwing your directional bias into the trash. In truth, the market doesn't care what you think and will do what it wants to do, over

and over again. Your only job is to respond to this harsh reality through a custom-fit strategy that takes advantage of the moment.

DEFINING YOUR TRADING EDGE

Do you have a trading edge? If not, how do you go about getting one? The modern market is a tough place to earn a living, with the majority of profits going to a minority of traders. Not surprisingly, the members of this elite group utilize definable trading edges at all times. Their advantage over you, me, and everyone else is characterized by a point of view, scheme, or plan of attack that separates them from the mindless crowd. It's often self-taught, because common strategies attract the majority to a few popular methods of playing the market. The sheer number of people acting in the same way eliminates the edge that made those strategies work in the first place.

Popular technical analysis principles offer no edge at all, but that doesn't mean you should go ahead and toss them out the window. Buried between the lines of your favorite patterns and indicators are powerful trading styles, methods, and strategic advantages. Tap this reservoir by setting off on a personal journey that truly comprehends its day-to-day applications. To start, build your own set of observations about market dynamics. Catalog the price swings that catch your attention, and then deconstruct them. How and where did they begin, how did they interact with the chart, and have you seen this type of behavior before? What kept you out of the trade the last time it happened? Was it a strategic decision, or did you just freeze when it was time to act? These small discoveries are the building blocks of a lifetime trading edge.

Many traders look for their edges through mechanical systems. Of course, large institutions use complex automated systems with great success. Some individuals can duplicate this workflow and find their edge through a systems approach, but most of us should just stick with discretionary trading in which we take voluntary positions based on a relatively fuzzy set of rules. A valid discretionary approach requires a heavy dose of personal responsibility because there's no one to blame but yourself if you're stuck in a hole at the end of the day.

Unfortunately, many traders who think they have a well-defined edge may have none at all or one that won't stand up to the test of time. The buy-and-hold crowd and long-side momentum players who ruled in

the 1990s lost their considerable edges each time a bubble burst, whether it was tech, real estate, or energy. The horrendous declines that followed each of those rocket ships highlight the most urgent aspect of a trading edge—it must hold up through the majority of market conditions.

Simple preparation and a good set of software tools give traders a minor edge over those less prepared for the market day. A real-time quote system and fast execution will pick the pockets of those who are stuck on slower terminals, but state-of-the-art technology can't turn a bad trader into a good one or sustain an edge that ensures your survival. Position management provides a more reliable edge because it takes a predefined set of rules and turns them into proactive decision making. But this control mechanism works only when it skews the characteristics of risk and expectancy in your favor. In other words, it has to increase profits on good trades and reduce losses on bad ones. In turn, this requires a working knowledge of leverage and position sizing, which is harder to learn than it looks.

A near maniacal obsession with entry and exit levels captures a trading edge better than any other technique or methodology because the practice aligns perfectly with position outcome. Simply stated, many traders are fixated on the big picture or underlying trend instead of the specific levels that will eventually yield profit or loss. Alternatively, those who focus ruthlessly on entry and exit prices are more interested in making money than in being right.

All the stuff in *Trading 101* gets you to the beginning of your journey, but it won't reveal the edge needed to survive in the financial markets. The bottom line: you need to travel that road alone, and for a long time. Unfortunately, if you don't know exactly what your edge is, you don't have one. In its simplest form, a trading edge is anything that lets you see and act upon market direction before other traders. Of course, you also need a well-organized strategy to take advantage of your observations, as well as skilled risk management after position entry. These twin elements are equally important in honing a trading edge that will support and underpin an entire career.

How do technical indicators fit into my personal trading edge? The bottom line is, this book is about price patterns and tape reading. A few hundred pages of technical indicators with a ton of arcane math might impress the Market Technicians Association, but I can't translate those derivative numbers into consistent profits. Over the years, patterns and the ticker tape have told me just about everything I need to know about market inefficiency. In fact, the more I stare at the hard right edge, the

less interest I have in overly complex technical indicators or in system testing.

Of course, I still use a few indicators, but they haven't changed much in the last decade. For example, I believe the Stochastics Oscillator is an indispensable tool for identifying the current buy-sell cycle, and On Balance Volume (OBV) tells fascinating tales when markets are near old highs or lows. And, as my last book pointed out, moving averages are a necessity in many trading strategies, including the big ones where institutions come into the market and make everyone else feel stupid. On the other hand, I've completely given up on MACD, regression analysis, average true range, rate of change, and a host of other substitutes for just looking at the price bars and letting them show me the "real" story of the trade. And to tell the truth, it's been wonderfully liberating to free myself from all the mathematical voodoo and to focus directly on the never-ending death match between buyers and sellers.

Three thematic elements, introduced in *The Master Swing Trader*, weave through my idea-to-outcome workflow from the moment I pull up a new chart until the last profit or loss hits my bottom line. These are the building blocks of my own trading edge, generally unchanged for the last two decades. Am I worried that revealing these secret ingredients will undermine my magical trading system? Of course not, because I don't execute a system, nor do I exploit any specific inefficiency when it comes to my trading. In essence, all I have is a set of observations that responds adaptively to changing market conditions.

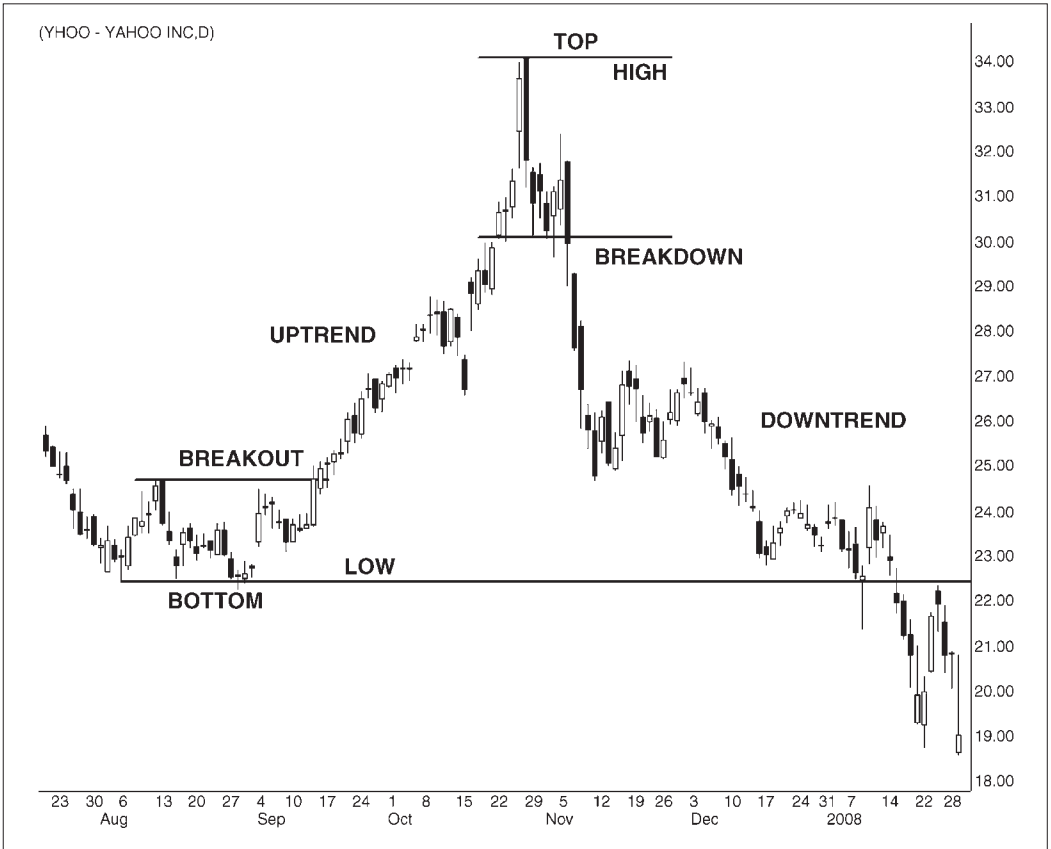
These three components provide the majority of my trading edge:

- **Pattern cycles** reboot the classic principles of stage analysis outlined in Stan Weinstein's *Secrets for Profiting in Bull and Bear Markets*.
- **Convergence-divergence** gathers predictive information by comparing two data points in the market and evaluating whether they support or resist the current trend.
- **Relative strength-weakness** records and analyzes the oscillation between buying and selling impulses in multiple time frames.

The nature of pattern cycles, in particular, needs to be understood instinctively in order to follow the techniques and strategies outlined in this book. In the simplest terms, this concept just follows around price action, from the formation of a basing pattern at a new low, the subsequent breakout and rally, and into the topping pattern that ends the uptrend.

FIGURE 1.3

Use pattern cycles to identify the current market stage. A basing pattern at a significant low generates a bottom that gives way to a breakout and new uptrend. The uptrend ends at a significant high, where a topping pattern precedes a breakdown and the start of a new downtrend. Conflicts between pattern cycles in different time frames generate the inefficiencies that translate into profitable trading opportunities.



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The cycle continues on the downside, with a breakdown from the topping pattern, the selloff that characterizes a downtrend, and into the final capitulation and formation of a sustainable bottom.

Pattern cycles are organized through the trend-range axis, which outlines the tendency of advancing price to alternate between uptrends, downtrends, and sideways impulses. These cycles occur in all time frames, from one minute through monthly charts. Trading opportunities emerge when viewing multiple time frames of the same instrument and correctly interpreting the interplay between their respective cycles. The most

profitable trades tend to occur at nexus points, where the low volatility of a trading range is giving way to the high volatility of a new trend.

It might be a stretch to believe you can build a lifetime trading edge with just a handful of basic structural concepts. The devil, as always, is in the details. Learning to read patterns accurately requires flipping through a million charts to see all the ways that price can move from one market stage to another. Clearly, this approach is not for everyone because the interpretive process is highly visual. Admittedly, many smart folks in the trading game need more indicators, spreadsheets, hand-holding, and generalized therapy before they're willing to assume risk based on a gap, triangle, trendline, or Fibonacci retracement.

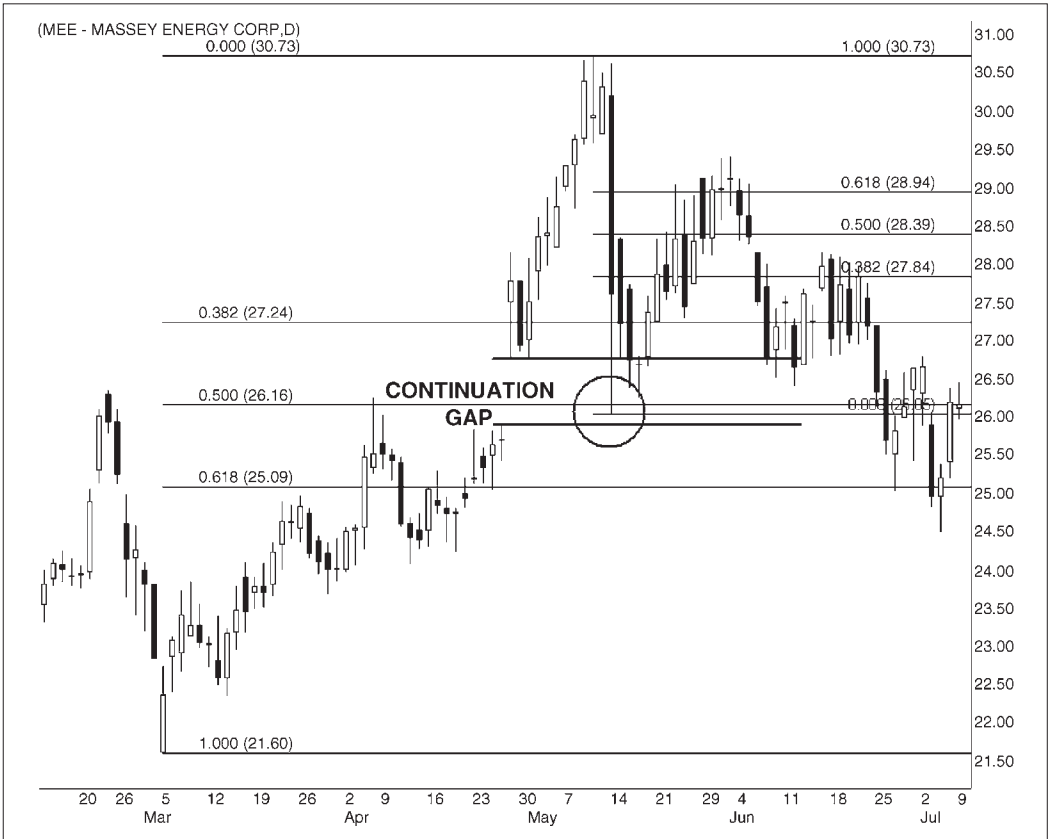
For the rest of us, however, delving deep into market structure and how it translates into price movement is a perfectly adequate method to build a lifelong trading edge. Here's an example. Edwards and Magee identify three gaps that are found in the evolution of many uptrends and downtrends. The breakaway gap erupts from a base or topping pattern, initiating the new trend. The continuation gap marks the halfway point as trend momentum builds and price surges. The exhaustion gap prints near the end of a trend, with the weakest hands capitulating just as a reversal is about to strike.

The continuation gap doesn't create a trading edge in a vacuum, because anyone can pull up a chart and find this common pattern. However, careful observation indicates that countertrend price action will act according to specific rules when retracing into this level. It's this tiny sliver of the pattern cycle puzzle that generates the dynamics of a profitable trade entry. Specifically, a retracement approaching or entering the gap should reverse sharply, before it gets filled. The subsequent bounce should then pull into the 38% retracement of the countertrend wave, at a minimum. I've taken this narrow observation and put together an entry strategy that works reliably because the majority of market players don't take the time to look ahead "three chess moves." And so it goes with most trading edges. To be truthful, most traders are reactionary (chasing the market around), rather than anticipatory (acting ahead of movement), because they're just plain lazy. Anticipation requires more effort than reaction because it utilizes a predefined set of risk-taking activities when patterns approach points of opportunity.

A single pattern or related observation can create multiple trading edges. For example, the continuation gap is easy to find after three gaps carve out an entire five-wave trend, but it can also be identified a few bars after it prints, just as the fourth wave gets under way. Elliott Wave structure

FIGURE 1.4

A lifetime trading edge can start with a few simple observations, like the strong tendency of price to reverse at a continuation gap. Massey Energy sells off into the continuation gap after completing a nine-point rally. Buyers step in within a few cents of the gap fill and trigger a high-profit bounce followed by a broader recovery up to 29.50.



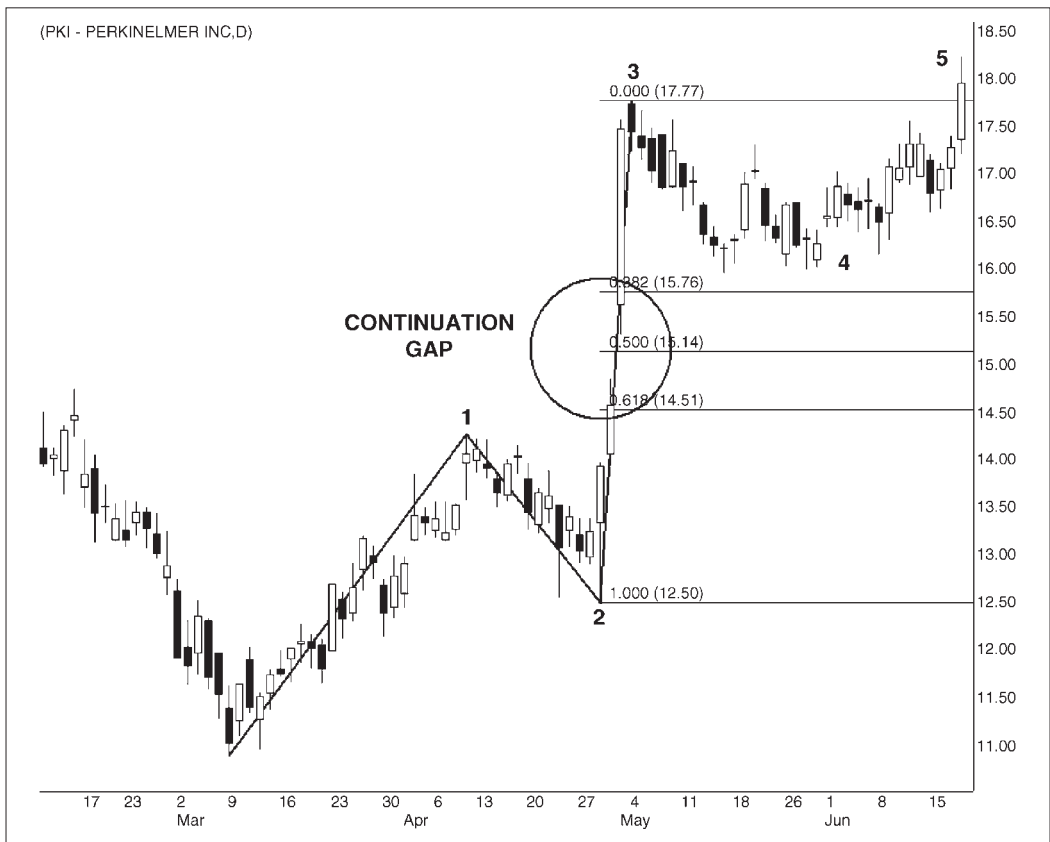
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points to three primary and two countertrend waves in an uptrend or downtrend. The continuation gap marks the middle of the second primary wave. So, whenever you see a gap in which price keeps moving and doubles the extension prior to the gap, you've identified a potential continuation gap. This is vital information because wave structure also predicts there will be a final rally or selloff, i.e., the third primary wave, before the trend finally ends.

This expectation creates an opportunity to enter a position within the sideways pattern that follows the gap, in anticipation of the third and final

FIGURE 1.5

Repeating price patterns uncover profitable market inefficiencies. The observant trader can use the continuation gap to locate an evolving Elliott five-wave rally set as soon as the third wave uptrend (second primary wave) gives way to the fourth wave consolidation pattern. Once identified, it's a relatively easy task to get positioned within the trading range and ride the fifth wave rally (third primary wave) to higher prices.



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primary wave. Frankly, I'm amazed at how few traders understand this relatively simple play, because I've watched it work over and over again in the last two decades. The trick, of course, is to understand price structure within the sideways pattern so your cash isn't tied up forever, waiting for the last big trend to get under way.

Many trading edges are made possible by the reactivity of our poorly prepared competition. For example, the narrow range tactics outlined in *The Master Swing Trader* take positions within small price bars near breakout levels, using the excitement created by reactionary traders to generate our

profits. We can also capitalize on their poor planning when breakouts (or breakdowns) lose momentum and they have no exit plan. In fact, there are several good opportunities when these weak-handed traders are caught like deer in the headlights. First, we can fade their positions, selling short when relative strength rolls over; second, we can wait at lower levels to buy in a classic pullback play as soon as they give up and capitulate.

It's vital that you stand aside when you have no trading edge, or you'll open yourself up to failure. The markets operate through an inefficiency engine that sets up good positions at key intersections of price and time. In between these points of light, trading can be choppy, volatile, and downright treacherous. You need to adapt to this feast and famine cycle, or you'll perish trying to fight it. Admittedly, trading when you have no edge won't incur massive losses most of the time. But it will hurt your discipline, dull your senses, and set you up for the big fall. At a minimum, it'll undermine your ability to act spontaneously when the *real* low-hanging fruit comes along.

2

C H A P T E R

THE CROOKED PLAYING FIELD

It started with the collapse of the bid-ask spread in the late 1990s. The Nasdaq market makers were sued in the middle of that decade for colluding on wide spreads that averaged between 25 and 50 cents for a standard mid cap stock that traded 2 million to 4 million shares per day. The repentant market makers finally agreed to major reforms that led to new SEC order handling rules in 1997. In turn, these regulations opened the doors for ECNs (electronic communication networks), like Archipelago and Island, which competed directly with the major exchanges for trade execution.

Then came decimalization in early 2001. In prior decades, market orders had posted simple fractions between the bid-ask spread. Decimalization proponents argued this type of pricing was unfair, because it let exchange middlemen pocket outsized profits. The new rule changed all that, allowing spreads on highly liquid stocks to fall to one cent and even lower at times. Trading volume exploded after the rule change, nearly tripling by 2003, because entry and exit decisions could now be subdivided

into seconds and minutes rather than hours and days. Of course, most of us humans weren't up to the task of trading for pennies, but this was no problem at all for a new generation of lightning-fast computers.

The dramatic success of the ECNs in stealing market share from the exchanges brought a revolution in transaction costs and bid-ask spreads. It also heightened efforts by Nasdaq to become a fully electronic market. As we know, the NYSE had to be dragged to this marriage altar, at least until Chairman Dick Grasso was forcibly retired in 2003. The pace of the electronic revolution heightened considerably after John Thain took the helm at the NYSE following Grasso's departure. The exchanges, instead of competing with the ECNs, decided to buy them outright in an attempt to retake market share. On April 20, 2005, NYSE bought ARCA, and, just two days later, Nasdaq responded by picking up the newly merged Island-Instinet.

The two acquisitions marked the death of the middleman, a.k.a. market makers and specialists, who had dampened market volatility for many decades. Consider how these universally maligned folks were tasked with "orderliness" because they were obligated to take positions against the general flow of supply and demand. However, the brand-new electronic markets had no middlemen or obligation to maintain stability, which would have been OK if the SEC promulgated appropriate rules that guided order flow within logical boundaries. But guess what happened when this regulatory body did the exact opposite, i.e., abolished existing rules that maintained order and then added new ones favoring chaos?

The SEC took another giant leap backwards on July 6, 2007, when it eliminated the uptick rule. The CBOE Market Volatility Index (VIX) jumped out of a three-year base in the midteens just two weeks later and never looked back. What triggered this surge in volatility? Simply stated, with no middleman in place to dampen order flow, program algorithms could hit sell bids repeatedly for hours and easily overcome human demand. The second shoe fell between August and October 2007 when the exchanges and other market centers phased in Regulation NMS, a.k.a. the "trade-through rule." This Orwellian nightmare required that entry and exit orders be routed to the venue that offered the best price. This sounded good in theory, but the rule turned out to be a total disaster in implementation. Regulation NMS infected the financial markets with a major destabilizing force because it fractured order flow into microscopic pieces, with institutions placing minimum size at the top of the bid-ask heap and refreshing in tiny segments, forcing market players to jockey around in a never-ending shell game.

Modern computer systems, acting in milliseconds, also had the power to back away from these elusive orders, making them disappear instantly. This vanishing act shifted monopolistic power into the index futures, which were also dominated by program algorithms and easily manipulated by relatively few transactions. That's why you'll now see bids on a thousand NYSE and Nasdaq stocks evaporate during a minor S&P 500 index futures downswing. Mere mortals, like old-fashioned money managers and public investors, just can't compete in this hyped-up electronic environment because their orders have little or no impact on short-term pricing. In a nutshell, there's no real supply to be taken out or real demand to be filled. The order fragmentation also set the stage for even more frightening consequences. First, the mythical market order book, open or closed, has effectively been destroyed. Second, the environment has spawned a new generation of program algorithms tasked with executing cross-market environments at faster and faster speeds, automatically and without human intervention.

The trade-through rule is also responsible for the rapid growth of dark pools and other stealthy, off-exchange systems that keep institutional strategies out of the public eye. However, the massive transactions on these complex systems still reverberate into equity and index prices through late reporting, options offsets, and exchange-traded funds. We also know that ETFs and leveraged ETFs have become the preferred execution routes for program algorithms due to liquidity, leverage, and dampened exposure to stock-specific risk. This places absolute power into the hands of a few wealthy institutions with enough cash to manipulate the index futures and a relatively small basket of equity funds.

Although originally designed to reduce the risk of equity exposure, modern stock derivatives now fully control the value of security prices. This is absolute madness but a perfectly logical outcome of an electronic market environment gone wild. It's also a highly dangerous situation because it's replaced supply and demand as the final arbiter of price discovery in the financial markets.

INDEX FUTURES

Back in the olden days (circa 1995), few at-home stock traders had access to the futures markets. In those ancient times, futures transactions were executed by hand, and there were no electronic "e-mini" contracts for the

S&P 500 or Nasdaq-100 indices. That all changed with the introduction of these enormously popular instruments and the implementation of the Chicago Mercantile Exchange (CME) Globex open access policy in 2000. At the same time, the bursting of the tech bubble triggered an exodus from equities into the futures markets. The reasons were twofold. First, big fish wanted the power to sell short during that bear market, without an uptick, and were attracted by the index futures' massive liquidity. Second, legions of small fry migrated to the index futures because the SEC's ridiculous pattern day trading rule, which requires that equity accounts hold more than \$25,000 to avoid draconian clearing issues, triggered a massive wave of frozen retail accounts. Together this odd couple started a market revolution.

Simply stated, index futures lead price direction in the equity markets. This correlation is more intense now than at any time in the past because the growth of index futures has paralleled an explosion in algorithmic programs, many of which are constructed with the sole purpose of exploiting inefficiencies between equities and futures prices. As a result, every futures swing now generates a proportional swing in the equity markets. In fact, many traders use index futures breakouts, breakdowns, and reversals to time the majority of their stock entries and exits. This makes perfect sense, given the tight correlation between cross-market instruments. It also overcomes the issue of conflicting technical readings, i.e., divergence, between the index futures and individual stocks. Take this analytical workflow one step further, and you can also assume that an outperforming stock will continue to outperform when the futures price rate of change increases in a sympathetic direction.

Index futures trade all night on the CME Globex exchange and have a profound impact on the opening of the U.S. markets. American traders tend to focus exclusively on the local session that starts at 9:30 a.m. New York time and ends at 4:15 p.m., but a better plan is to track convergence-divergence relationships between the 24-hour and day-only intraday charts. The 24-hour session carves out high-low swings that may come into play early in the U.S. session. It also generates a unique relative strength cycle visible on a 5-3-3 Stochastics. We can use this conflicting information by marking out notable highs and lows on the day-only pattern and then looking for Stochastics crossovers on the 24-hour pattern. Tight correlation (convergence) between day-only and 24-hour index futures relative strength is a precursor to a strongly trending equity market, while conflict (divergence) between the two patterns points to a trading range and intraday chop. Just keep in mind that these short-term signals provide just

FIGURE 2.1

The 24-hour and day-only CME Globex index futures can tell vastly different tales. A half hour after the open, 5-3-3 Stochastics points to a buy signal on the day-only 15-minute Nasdaq-100 index futures chart and a sell signal on the 24-hour chart. These conflicts are common in the morning hours of the U.S. session. Divergence between the indicators during this period advises caution, while convergence tells the trader to act more aggressively.



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one piece of the trend puzzle and shouldn't be used in a vacuum to make sweeping judgments about market direction.

Institutions use the index futures and corresponding exchange-traded funds to initiate major algorithmic strategies because it doesn't take much capital to put a trend into motion. These programs are symbiotic, meaning they attract waves of capital from other sources looking to piggyback onto the strategies. It's urgent that traders recognize directional program-related activity as early as possible because they have a domino

effect in which sector after sector responds to the trending impulse and then follows in lockstep. Adding to the effect, traders and market-making sources then back away from their bids, close adverse positions, and take new positions in sympathy with short-term momentum.

Futures-related program trading has its greatest impact on the broad equity markets when the public is on the sidelines. Conversely, contrary programs (buying in a downtrend, selling in an uptrend) are far less effective when the public is driving a strong equity rally or dumping positions in a major selloff. This general rule has become more significant in recent years due to the breaking of multiple bubbles that kept public traders and investors fixated on their stock market portfolios.

How can equities hold natural support or resistance levels given the endless tug and pull of the index futures and ETFs? The answer is that they don't hold these levels nearly as well as they did in the past. This is the primary reason pattern failure strategies have become so important to survival in the last 10 to 15 years. Index futures domination has contributed to another mutation in equity price action, known as channeling behavior. As it turns out, these instruments affect short-term patterns to a much greater degree than long-term patterns. Well-established stock trends can survive this time-delimited volatility but tend to carve out much wider price swings than they did in past years. In turn, this stretching behavior contributes to a flood of channel patterns on daily and 60-minute charts.

Profits on longer-term positions require stops outside the boundaries of these volatility-driven channels, which raises all sorts of new reward:risk considerations. It's our nature and training to place a stop loss under an old low or above a moving average, but swing size is now attuned, in the short term at least, to index futures oscillations and not the technicals of the individual pattern. In a nutshell, it's nearly impossible to place a successful stop without first estimating the impact of non-stock-specific volatility triggered by the intraday markets.

Fortunately, this process is easier than it sounds because it requires just two more charts on your trading screen—one for each of the two major futures contracts. I recommend simple 15-minute charts, with 50- and 200-bar EMAs and a 5-3-3 Stochastics. Then go trendline crazy because futures traders are fully aware of every trendline, moving average, and high-low pivot in their special universe. Once you've drawn out those lines, it's simply a matter of expecting volatility to spike during breakouts, breakdowns, and when index futures move into those magical zones of conflict known as gaps.

While index futures are vitally important for short-term trading strategies, it's a mistake to avoid positions lasting one to three weeks just because you're afraid of adverse index swings. Technical analysis, as I'll discuss in Part Four, tends to work more reliably as patterns and trading opportunities move farther out on the time spectrum. So when holding periods can be measured in weeks rather than a few hours or a single day, broad relative strength measurements offer more actionable data than wiggles and waggles in the futures markets.

PROGRAM TRADING

Program algorithms have delivered massive liquidity into the tape, but at a major cost to the human population because computers don't suffer from the twin emotions of greed or fear. That sounds OK until we consider that every market crisis in history has been resolved when rising fear induced a crescendo of selling pressure that triggered a capitulation event or phase. These transactions now account for the vast majority of all market activity. This huge volume lets the institutional desks running these programs control short-term direction with a single switch because piggyback strategies will "pile on," creating a positive feedback loop that cascades price from one level to another.

The gargantuan effect of program trading can be traced back to the advent of decimalization in 2001. Average transaction size has collapsed since then, as computers slice and dice obscure strategies into smaller and smaller pieces. In turn, this dampens perceived volatility while it undermines the routine flow of buying and selling pressure.

I say *perceived* because VIX has risen sharply since the advent of program algorithms. However, it's likely these new-age strategies have mastered VIX's internal code and can make markets move without triggering traditional volatility patterns.

This has macabre implications for the market's future because greed and fear are natural tempering mechanisms for price discovery. Imagine a world in which 400-pound market gorillas can take index futures and equities prices anywhere they want them to go at any time, and with relatively limited monetary risk. Pretty scary stuff, huh? In this regard, I recommend picking up *The Black Swan: The Impact of the Highly Improbable* by Nassim Nicholas Taleb. Black Swan Theory examines our willingness to ignore the impact of large-scale events on historic market outcomes.

The author points out—correctly, I believe—the likelihood of calamitous market events occurring with far greater regularity than admitted to or expected by the purveyors of Wall Street and investment mythology. If his theory holds true, the cold-hearted trading machines of the twenty-first century could be hurling us into a series of 2008-like disasters in future decades.

Electronic options exchanges and exchange-traded funds aggravate the influence of equity program trading. Many algorithms hedge their plays through the various derivatives markets to create a variety of buying, selling, or neutral strategies. In turn, these cross-market influences trigger a powerful directional impact on equities that may be counter to the program's net result. This is bad news for technically oriented traders staring at double tops and moving average crossovers, because we think our charts should follow the natural laws of supply and demand even though algorithms passing through multiple cross-markets are undermining order flow and camouflaging directional bias. To complicate matters, institutional bias and their computer programs don't necessarily follow identical paths. For example, contrary algorithms work overtime when institutions are reallocating capital but want to hide their intentions from the public. During those stealthy events, artificial buying will hide real selling activity, while artificial selling hides real buying activity.

It's no mystery how traders need to respond to the overriding influence of program trading. We need to stop fighting their activity and retool our day-to-day strategies to work in harmony with the institutions executing these "bots." This transformation requires three basic shifts in thought process, trade planning, and position management:

- Trade in the same direction as the institutional money flow.
- Execute a previously devised escape plan when adverse programs hit the market.
- Stand aside or reduce size in the choppy middle ground, when programs are focused on grinding out small profits.

We must follow institutional money flow if we want to be profitable. This is difficult to accomplish in the real world because there's a persistent belief that program trading follows common technical analysis rules. In fact, nothing could be further from the truth. Program algorithms apply complex math that's disconnected from common sense or popular trading strategies. Just consider the background of algorithm guru James Simons, who was a mathematics professor breaking military codes during the

Vietnam War before turning his attention to the financial markets. In other words, try to visualize *Wall Street's* Gordon Gecko tapping John Nash's *Beautiful Mind* to find and formulate market-moving trading strategies. That's the explosive reality of our electronic market landscape. The bottom line: it's highly doubtful that double bottoms or pretty triangles ever come up for discussion in the control rooms of these multibillion-dollar operations.

Another workable response in a computer-dominated market is to stand aside while the index futures swing between major pivot prices. As I noted earlier in this chapter, program activity is tied intimately to the index futures because equity players, pile-on strategies, and arbitrage mechanisms all react instantly to futures oscillations. This symbiosis gives quants, funds, and institutions a cost-effective means to impact short-term market direction. However, the interests of human and silicon traders tend to converge at large cycle support or resistance levels. For this reason, it still makes sense to sell near the top and to buy near the bottom of a broad range. The difficulty lies in the mental mechanics that induce traders to feel bullish at resistance and bearish at support. Computers aren't burdened by this emotional baggage and just do their jobs, as long as someone hits the right buttons. This transistorized edge highlights the psychological side of the human-algorithm interface. In a nutshell, programs never fail to pull the trigger when their signals go off, unlike their flesh and blood counterparts.

Finally, keep in mind that program trading doesn't work as well when speculators and the public are active in the financial markets. Their emotional participation works to balance out the equation, allowing common support and resistance levels to hold more firmly despite algorithms keeping up pressure near contested price levels. This, in turn, yields those wonderful periods of low-hanging fruit that we depend upon for a good share of our annual profits.

PROGRAM TRADING: OBSERVATIONS AND STRATEGIES

Organizations running computer algorithms are highly secretive, which means we'll have to wait for a tattletale book before learning the dark mysteries of the quant universe. However, traders have a powerful tool at their disposal that lets them deconstruct these black boxes and formulate

sympathetic strategies. It's called tape reading. Indeed, in the market's long history, nothing has ever come along to bypass, undermine, or denigrate this near legendary skill set.

So, in no particular order, here are a few things we know about trading bots and their considerable influence on intraday price action:

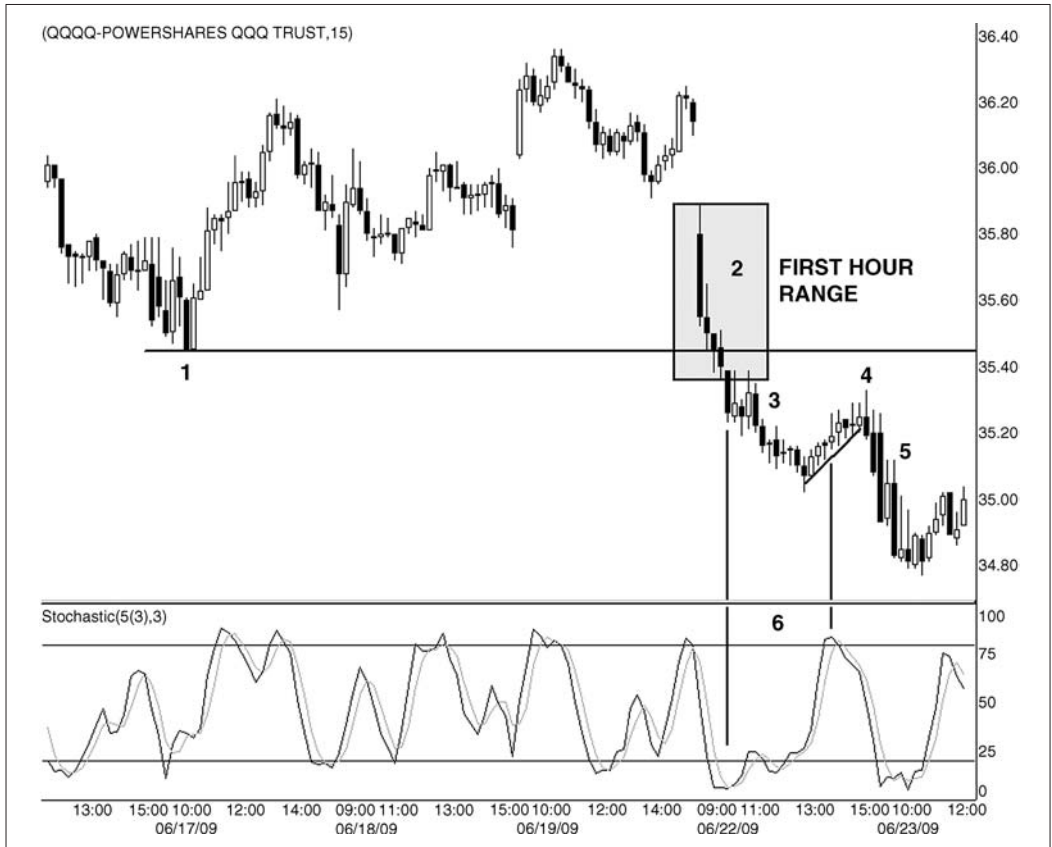
- The market often prints the highs or lows of the day near the lunch hour.
- Directional programs are more numerous in the first hour, near 2:15 p.m., and in the last 30 minutes of the session.
- Up-down volume higher than 80:20 or lower than 20:80 predicts trend days that show persistent channeling behavior.
- Support and resistance levels are vulnerable to repeated traps, characterized by gaps in the opposite direction of the prior day's closing momentum.
- Open-to-close daily program strategies are prevalent, with early themes persisting through the entire session but then disappearing overnight.
- As a result of open-to-close strategies, rotation is now a daily event, which is nearly unpredictable through routine technical analysis.
- As a result of open-to-close strategies, intraday trend reversals are less likely than they were 5, 10, or 15 years ago.

These observations take us into new territory as traders because they go against the grain of common market wisdom. For example, we expect that a strong close in a trending market will yield a strong open (follow-through) the next day, but this popular strategy has been a complete loser's game in our modern electronic environment. On the flip side, since first hour price action, whether strong, weak, or choppy, tends to persist through the entire session, we can take advantage of this expectation with sympathetic strategies. These include building positions during intraday countertrends, buying/selling 15-minute breakouts or breakdowns, and simply standing aside because the chop favors no risk at all.

As illustrated in Figure 2.2, the Nasdaq-100 Trust (previously the Powershares QQQ Trust) gaps down on June 22. The selloff carries through support (1) at 35.45 at the end of the first hour. Two tape reading clues point to the opening phase of a downside trend day. First, the fund fails to rally back into the gap by the end of the first hour, or even bounce. Second, the selloff breaks a notable support level that isn't remounted in

FIGURE 2.2

Nasdaq-100 trend day.



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the same time period. The first hour range (2) gives us narrow boundaries to set up our first trade of the day. Price falls to an intraday low between 10:30 a.m. and 10:45 a.m. and then consolidates (3) for nearly an hour, testing the boundaries of the broken range. We sell short this bounce into resistance, with a stop loss within the gray box, or wait for a breakdown from the small sideways pattern and then sell short. The earlier entry is more favorable because 5-3-3 Stochastics (6) is starting to roll higher by the time that price hits another intraday low, during the lunch hour. Our next trade comes in the final hour, when the fund bounces higher in a bear flag (4), which finally breaks to the downside. The small candlestick at the

top of the flag, thrusting toward 35.40, is typical of swing highs and lows during trend days. With diabolical precision, the intraday market rarely changes direction until the controlling side (bear flag buyers in this case) makes a final commitment, which is then punished almost instantly.

This late entry demands one final and urgent decision—whether or not to hold the short sale overnight. It’s a tough call because of the observation that program strategies tend to disappear at day’s end. However, this is counterweighted by an equally powerful observation that intraday lows on trend days will be tested or broken before the market finally reverses. You’ll note the final hour low near 35 doesn’t get tested by the closing bell, increasing the likelihood of more selling pressure (5) early the next day.

Of course, there are other favorable entries in this example, including a momentum short sale right after the open. But we have less information to work with early in the session because it takes time for program algorithms to reveal their strategic footprint. We also have access to less macro-data, like market breadth and up-down volume. Both of these elements point to downside trend days through lopsided numbers, like 1800 to 2000 down issues on the NYSE and Nasdaq, as well as 80% down volume on both exchanges.

Now let’s consider the impact of program algorithms on the traditional Level II screen, better known these days as market depth. First, realize that market making itself has become a specialized form of program trading, replacing the traditional middlemen of prior decades. Now, add in the destabilizing impact of Regulation NMS, a.k.a. the trade-through rule, which requires a “best price” display at all times. The end result: computer-driven bid-ask spreads that zoom higher and lower at the speed of light. Bid-ask size has become a vestigial organ in this headache-inducing display because computers can back away from quotes faster than you can hit your execution button. In addition, orders can now be subdivided among numerous market centers, with iceberg quotes hiding real size, interest, and intention. Finally, the explosion of third-party centers of liquidity, like the infamous dark pools, guarantees the information you see on the Level II screen doesn’t represent true supply and demand.

However, the survivalist trader still watches the market depth screen closely because the electronic paint job tells valuable tales, in spite of all the smoke and mirrors. Here are three strategies to help you take advantage of your observations:

1. Empty at the open. Without middlemen to ensure orderly markets, the opening has become a wasteland of illiquidity. In fact, it isn't unusual to find dollar bid-ask spreads on stocks that trade in excess of 2 million shares per day on average. This vacuum is especially prevalent on flat mornings, when electronic market makers display no quotes at all because they're sitting back, waiting to see which way the wind is blowing.

Observant traders can step into these issues with lowball quotes during the last two minutes before the open and often get filled for instant profits. You can take this predatory strategy one step further on the NYSE, which often delays the opening quotes for 5 to 15 minutes, in a throwback to the specialist era. Following entry, take profits immediately by posting a quote just inside the opposite extreme. If this isn't possible, wait for the bid-ask spread to tighten, and place a profit protection stop just behind your entry.

2. Step down, step up. The bid-ask spread on targeted stocks will step up or step down in a persistent oscillation when a major buying or selling program hits the index futures. Recognize this phenomenon by the rapid reset of prices at lower levels (in response to a selling program) followed by a sudden uptick that fails to reach the last level of stability. Price action then evolves into rinse and repeat mode, which mimics the two-steps lower, one-step higher dynamic over and over gain.

The trading trick, when you come across this phenomenon, is to enter the market at the same time the programs complete their work and exit the market. You can recognize this turnaround in the first counterimpulse that retakes 100% of the last level of stability. When you see this happen, enter the trade during the next oscillation in the program direction.

T A B L E 2.1

Impulses during a Program Selling Event
1) 38.01 – 37.80
2) 37.85 – 37.65
3) 37.70 – 37.55
4) 37.65 – 37.30
BUY 5) 37.68 – 37.45

In the Table 2.1 example, price drops in selling impulses ranging from 15 to 35 cents. Following the third impulse, it bounces to 37.65 and then sells off to 37.30. The next bounce reaches 37.68, which triggers a buy signal on the subsequent down wave, with a logical stop loss just under the low of the fourth impulse, at 37.30.

- 3. Pop tops/bottoms.** This is a twenty-first-century variation of a tape-reading strategy that was popular in the early days of Level II, back in the 1990s. It starts with an assumption that trading bots can see the hidden location of liquidity pools. It then relies on a long-observed tendency for price to surge into these magnetic levels, in wide range bars, before it reverses. For the strategy to work, however, the stock needs to be trending in the direction of the eventual spike as opposed to oscillating in a trading range that suddenly thrusts higher or lower.

Use these magnetic moves to initiate fading entries (i.e., positions in the opposite direction of the spike) or to take windfall profits on open positions. The contrary strategy is even more effective when the short-term trend has traded into an easily observed support or resistance level, with the surge then pushing price through it. This sounds contradictory according to classic TA principles, but consider how often you've watched an intraday play wind up and rally through resistance, draw in excited traders, and then reverse, trapping them in a swift decline. This thrust-and-failure dynamic takes us back to the concept of hidden liquidity pools. Simply stated, the majority of electronic market making is geared toward whatever direction yields the greatest volume. From an outsider's standpoint, we can view this activity as a continuous search and destroy mission, with trading bots hunting down and triggering stop losses, common entry/exit signals, and large retail orders.

Risk increases on open positions whenever electronic market-making activity combines with larger-scale buying or selling programs. Just as smaller hedge funds respond to program impulses by piggybacking or by stepping aside, we need to consider our options when big trading bots take firm control of the tape. Our first tendency when this happens is to loosen stops, so they aren't triggered by the whirlwind. This makes perfect sense, except for one diabolical aspect of our modern electronic markets—algorithms are insanely effective at adjusting to intraday volatility. This is why loose stops that survive routine buying and

selling impulses get hit with amazing precision during program events. Even worse, the program-driven strategies usually die out, like clockwork, right after we get shaken out of perfectly good positions.

This increases the utility of our second option, which is to just back away with other market players. Of course, this has an emotional cost because we're committed to our positions and want to *outlast* the bots. However, with transaction costs almost nil in our modern environment, it often makes sense to just hit the exit button and reestablish the position, or basket of positions, after the storm clouds have passed.

ACTION-REACTION-RESOLUTION

It would be nice to wrap up this discussion after posting a few bullet points about the index futures and program algorithms, but life isn't so simple in our twenty-first-century markets. Massive liquidity across a spectrum of futures, debt, currency, and derivative exchanges ensures that cross-currents outside the realm of ordinary supply and demand impact every aspect of our trading activities, from initial position choice to final profit or loss. Despite this enormous complexity, many technicians still believe that pretty patterns predict everything they need to know about trend direction, extension, and duration. Sadly, this is a weak-handed view because convergence-divergence oscillation between equities and numerous world markets exert tremendous power over price movement.

In the real world, cross-market forces can trigger cascading selloffs on the most bullish patterns and parabolic rallies on the most bearish ones. That's not to say we should just abandon our pattern analysis because it doesn't work anymore. In fact, nothing could be further from the truth. But using triangles, rectangles, and trendlines to make trading decisions in a vacuum, and without consideration of the dominating external forces, is a surefire way to lose money.

Which brings us back to the concept of pattern failure, a central theme in *The Master Swing Trader*. When the book was published in 2000, traders were just entering a tough environment in which classic technical analysis had started to lose its historic potency. In the simplest terms, technical analysis stopped working after the bubble burst, because its Internet-trained adherents had become the majority that needed to be punished, and just like every overplayed inefficiency, the profit door was slammed shut.

FIGURE 23

Breakouts and breakdowns evolve through action-reaction-resolution (1-2-3) cycles. Cerner rallies above resistance at 40, after a four-month basing pattern. The breakout sets off the *action phase* with a rally that gives way to a series of whipsaws, which are common during the *reaction phase*. Volatility quiets down for a week, and price then surges above the first high, triggering the long-awaited *resolution phase*. This confirms the initial breakout and initiates a fractal 1-2-3 cycle in a smaller time frame.



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To this day, traders chase around deceptively simple breakouts and breakdowns without recognition of many ways that pattern failure will undermine their bottom-line results. It's really a shame because a single addition to their workflows will address this critical issue in an efficient manner. It starts with a deconstruction of the three-step mechanics you'll observe in the

majority of breakouts, breakdowns, whipsaws, and pattern failures. I call this the action-reaction-resolution cycle, or simply the 1-2-3 cycle.

Successful breakouts and breakdowns tend to occur in three phases. They begin when price pushes through support or resistance on increased volume. We'll call this the *action phase*. Price expands a few ticks or points and reverses, which initiates the *reaction phase*. The instrument then shifts into countertrend mode and spawns the first pullback, where sidelined players get a "second chance" opportunity to buy or sell near the support or resistance level. If all systems are working as intended, a second impulse eventually kicks into gear and carries price through the initial swing high or low. This thrust marks the *resolution phase*, which confirms the breakout or breakdown.

Whipsaws, as well as false breakouts or breakdowns, result when supply-demand dynamics fall out of balance. Whipsaws are defined by choppy swings at or near support or resistance levels. The natural tug and pull between bulls and bears generates most whipsaws, but program algorithms also impact this activity with trend-neutral strategies that target common stop levels in order to generate volume. Whatever the source, whipsaws are responsible for many of the losses in a typical trading portfolio. This remarkably efficient engine of destruction can take control whenever breakouts or breakdowns fail to generate well-organized reaction phases.

The resolution phase can unfold quickly once whipsaws start to die down. Volatility reduction induces price contraction that, in turn, triggers a wave of fresh entry signals. Positive feedback then kicks in and generates the directional surge needed to carry the instrument through the initial high or low swing. Price exceeding the high or low signals successful completion of the breakout or breakdown and the initiation of a new 1-2-3 cycle in a smaller time frame.

Pattern failures occur when price action traps the side of the market acting upon the initial breakout or breakdown signal. Using popular technical strategies, the crowd chases into positions at these inflection points but is then vulnerable because follow-through depends upon a second crowd seeing the next set of technical signals and jumping in behind them. With these dynamics in play, false breakouts and breakdowns can occur for two reasons. First, the second crowd fails to appear on schedule. Second, predatory programs and traders that have deconstructed these impulses take aggressive contrary positions. The resultant counterswing when both adverse dynamics hit at the same time can be breathtaking and utterly destructive to trend-following positions.

You'll find this 1-2-3 cycle is a recurring theme as you move through this book because it's intimately tied to survivalist trading techniques. For now, just go back and memorize the pattern because it will provide an immediate benefit to your bottom line. And, if you have the courage, pull up your trading records and examine your biggest losers, with a sharp focus on 1-2-3 cycle elements that would have saved your backside.

WORKING WITH CROSS-MARKET INFLUENCES

Cross-market analysis provides a well-defined trading edge because it helps us to measure risk for each segment of the 1-2-3 cycle in our proposed trades as well as in open positions. Sympathetic markets trending in the same direction as our signals increase the odds for a profitable resolution phase. Alternatively, adverse markets lower the odds for a successful resolution phase. For example, choppy Asian markets make it more likely that our non-U.S. positions in Web portals, steel mills, and agricultural feed producers will stumble through whipsaws in the New York session.

What cross-markets do you need to watch during the trading day? Start with an active subscription to the CME Globex index futures. If you're strapped for cash, you can pull up index-related exchange-traded funds as a replacement, as long as you keep in mind that these instruments can't access the 24-hour markets. Next, add a variety of energy and commodity markets to your real-time view. Again, ETFs will provide an alternative, but choose them with care because they may not track the futures markets reliably, as many traders and investors discovered when the United States Oil Fund crashed in 2008. In any case, data fees for energy and commodity futures are worth their weight in gold, even if you don't intend to play crude oil or precious metals directly.

Equity traders can track price action in other world markets, like the European and Asian bourses, bonds, and currency pairs by just paying attention to the financial headlines. Currencies, in particular, are specialized animals that can respond violently to global economic shifts, but unless you intend to trade them directly, just throw up a EUR/USD quote, read the financial news, and forget about the other crosses. Use country ETFs to observe gyrations in the most active world markets, but keep in mind that these instruments don't track foreign markets outside of U.S. exchange hours, so they have limited value during the trading day. Of course, you can also add foreign markets to your real-time data subscriptions, but the cost can be prohibitively high.

As a general rule, avoid long-term positions when world markets are overly volatile or unpredictable. In addition, it's absolutely vital to have a preplanned fire drill ready to go when you awake to discover shock movement in the overnight markets. These seismic shifts in prices and perceptions often require aggressive utilization of the premarket session in order to reduce risk ahead of the New York open. Look for more detail about this specialized arena of battle in Chapter 10. Alternatively, think clearly when an overnight shock hits the markets, because ill-advised decisions by weak-handed players can trigger a host of predatory trades. For example, there's often a quick flush that shakes out traders reacting to the traps that have been sprung overnight. This capitulation can set up a counterreaction that fills an early gap or throws momentum chasers into a secondary trap that can be exploited later in the session.

Economic releases and Fed meetings affect many markets simultaneously, triggering volatile spirals of price discovery that both increase risk and set up excellent trading opportunities. Not surprisingly, price action after big economic shocks generally follows an action-reaction mechanism that's nearly identical to the 1-2-3 cycle. Traders initiate the cycle dynamics by chasing the logical direction based on the bull or bear quality of the shock. A counterimpulse then hits the tape, testing the new boundaries triggered by the event. Finally, the market discounts the news and shifts methodically toward a new price level, rewarding some and punishing others.

The major world markets have natural relationships between each other, and with specific economic segments, that predict the long- and short-term behavior of stock prices. Here are five common relationships that guide a large segment of the equity population:

- An inverse relationship between commodities and bonds
- An inverse relationship between the U.S. dollar and commodities, especially gold
- A positive relationship between stocks and bonds
- Copper as a proxy for industrial activity
- Gold as a proxy for inflation-deflation
- Oil as a proxy for economic growth-contraction

Energy and commodity markets, in particular, have become central to our trading strategies in recent years. This is especially true because raw materials correspond directly with a broad set of related equities. More importantly, these issues tend to do their own thing rather than follow around the S&P 500 or Nasdaq-100 indices like obedient puppies. This

independence provides traders with profitable alternatives when price action in the major indices doesn't support our favored strategies. However, it's important to remember that commodity futures and their underlying stocks rarely move in perfect harmony because the interrelationships are complicated, to say the least. Within the energy complex, for example, companies might focus on refining, exploration, distribution, drilling, or a subset of these activities. Each of these specializations has a relative dependence on daily fluctuations in crude oil or natural gas prices.

When trading energy stocks to take advantage of rising crude oil prices, it's best to pick issues that are (a) outperforming the futures and (b) outperforming other energy stocks. As a general rule, small cap explorers offer the most speculative positions, while dividend paying trusts and integrated oil companies offer the most safety. Traders love the drilling and pipeline operations because they can track performance directly against the hugely popular Oil Services HOLDERS Trust. In addition, direct country plays, like Brazil's *Petróleo Brasileiro S.A.*, work extremely well as proxies for rapidly rising or falling crude oil prices because they're trading on the value of their underground reserves.

A similar alignment and convergence process runs through the entire metals group. The gold futures contract has a unique position in this complex because it's a highly emotional instrument tied to fear, inflation, hedging, and Asian demand. Gold bull-bear cycles also tend to be long lasting, with trends measured in decades rather than in months or years. As a result, day-to-day movement of precious metals equities rarely tracks the major indices.

It's easy to lose money playing these stocks due to the misconception that price action will track gold, silver, or platinum prices. While the longer-term trends of gold, silver, and platinum miners will generally track commodity futures, weekly performance is more intimately tied to company hedging practices, proven resources, and speculation on new resources. This is a two-edged sword because a handful of these mining operations will strongly outperform the underlying commodities while the majority underperforms.

As with other sectors, it's best to choose the strongest equities in the precious metals group for long positions and the weakest ones for short positions. The most effective technique to plot this relative performance is to compare the current price to the 200-day EMA. I'll discuss this important measurement tool in Chapter 4.

TRADING VERSUS TECHNICAL ANALYSIS

There's a major problem with technical analysis in our modern markets. As it turns out, interpreting price charts is a relatively easy skill set to learn, while applying a cohesive strategy that makes money is infinitely more difficult. Many traders gravitate toward chart reading at the expense of everything else, because they're too lazy to study the market's numerous quirks and nuances. After all, it takes less effort to draw a few lines marking out support or resistance than to understand the multitude of forces that really move the financial markets. In truth, no one is printing money these days, and you'll need to do more than read the pretty patterns in order to book a year's worth of profits.

Of course, everyone is an armchair technician because it takes little work or commitment, but putting your money on the line every day is another story. Real-life trading requires a detailed plan of execution, a strong stomach, and a ton of patience. And it's much harder to do than impressing your online buddies with a sea of trendlines, flags, or double bottom patterns. Admittedly, I look at a ton of charts each day, but my primary objective is to find intersections of price and time where other technicians are likely to get trapped, become irrational, or trip over their own belief systems. In this way I can use their overreliance on chart reading to my personal advantage. It's just one of the many strategies that takes popular technical analysis and turns it, diabolically, against its most ardent disciples.

Do you flip through the charts in a role-playing exercise, trying to visualize all the rallies or selloffs where you would have been right if only you'd taken action? If so, you might be reinforcing a fantasy mindset that won't help your bottom line because, in essence, you're engaged in unconscious risk-avoidance. Of course, there's nothing wrong with using the charts to filter out noise and to make better trading decisions. In fact, it's a required practice on the road to profitability. But be warned: price patterns hide so many perception traps that misinformation often defines reality.

Now take this little quiz. Your honest answers to these three questions should tell you whether you're a trader or just a closet technician:

- Can you translate what you see on the chart into a plan that works for that market, that time frame, and your pocketbook?
- Do you see all the traps and whipsaws that might tear through your stops before price finally moves on to your objective?

- How will you deal with the panic attack when the market moves against you because program algorithms are controlling the data flow?

Market whales can paint the tape however they choose, but their absolute power isn't the only problem with classic technical analysis these days. As I noted earlier, so many weak players rely on chart reading that common technical perceptions no longer define a workable edge. In truth, the modern markets spin off a thousand shades of reality, and what you see depends on how you look. Ironically, long-term profitability demands an intimate knowledge of the numerous ways that charts and patterns generate false information. It also requires an adaptive trading strategy that avoids or mitigates the shakeouts, fakeouts, and downright lies that price charts radiate each day.

Technical analysts get kudos for their market calls, but the practice is often self-serving and overrated. It also fosters a sports betting mentality that does little or nothing to generate consistent income. In addition, it's a popular deception that gives the public someone to blame when things turn out poorly. As strange as it sounds, profitability has little to do with being right or wrong. Rather, long-term survival depends on a capability to manage risk and to accurately compute the odds in your favor in real time. It also requires peaceful coexistence with the technical confusion, divergence, and misdirection that pops up at every turn.

In other words, you need to pay a lot more attention to the diabolical mind of the market than to all those fancy trendlines on your favorite chart.

THE REAL WORLD: AWAKENING TO INSANITY

There's been an overnight selloff in the Asian and European markets. You held three long positions overnight, and you're now forced to deal with the consequences.

The rally day is winding down, and it's time to decide which positions to hold overnight. After the pleasantly strong session, you're willing to carry more exposure than usual, expecting eager bulls to keep up buying pressure in the morning. Sensing an opportunity, you add shares to two open positions and even throw in a "lottery ticket," not wanting to miss

any profits. At the end of the day, you're holding 500 shares of Apple, 1,000 shares of General Mills, and 1,500 shares of NetEase, a Chinese momentum play.

You're up with the birds the next day, fully prepared to see glowing green lighting up your trading screen, confirming expectations for a strong and profitable opening. Instead, everything has fallen apart overnight, with panicky traders worldwide getting out at any price they can. Your stomach does back flips when you realize those great positions you took overnight now look like sitting ducks, lined up nicely in a row for sellers to shoot down. Indeed, it's going to be a rough morning in which a few bad decisions might cost you thousands of dollars in shock losses. So where do you start the triage process, and how do you get out of the way of the moving train?

Right away, you notice the selloff started in Asia, with big indices in that part of the world down almost 5%. This is a huge problem because your highest-risk position, the Chinese tech play, has already been trading and might be heavily impacted by the selloff. In addition, the stock is naturally volatile, swinging through two, three, or even four points on a relatively quiet day. The potential risk hits you like a brick wall, demanding your undivided attention before you look at your other positions.

Apple is a mixed bag because it's an archetype for many things, marketwise. For starters, it's a Nasdaq-100 component, which warns that any sell programs hitting the index futures could rip a big hole in the downside. It's also a punching bag for hedge funds looking to pull down the entire market through narrowly targeted selling pressure. This works both ways, however, because equally powerful forces wanting to trigger short squeezes often bid up the stock to force buying pressure to ripple through the tech sector.

Finally, General Mills could turn out to be the saving grace because big selloffs often trigger rotation into defensive groups like foods, soaps, and cosmetics. But you really don't know yet if the few buyers out there will feel like risking their capital on anything at all that day. So this stock moves into the "observe and report" category, in which you're hoping for resiliency while keeping one nervous finger on the exit button.

Ironically, your response to the early morning crisis will be easier if your exposure is more heavily weighted to the S&P 500 or Nasdaq-100 indices. In either case, you can sell short the related futures contract in the premarket and balance out your long side exposure. More often, positions in trading accounts tend to show weak correlation with the

major indices and need to be managed independently when disaster strikes.

Take a moment to consider just how bad things really are. Many selloffs are just shakeout events in which prices bounce back quickly after weak hands give up and sell out. A good way to approach this inquiry is to look at overnight trading ranges for the CME Globex index futures, as discussed earlier in this chapter. Your primary question: are the index futures trending lower, or are they caught within relatively narrow boundaries? One-way movement in the wee hours of the morning is far more dangerous than a two-sided market. This positive feedback loop predicts that index prices could drop far lower and drag down positions more violently than expected after the opening bell.

Premarket quotes confirm your worst fears, with Apple and NetEase trading down between 2% and 3%. You can make an immediate sell or hold decision with the Apple quote because the stock is highly liquid and trading a tight spread in the premarket session. NetEase is more confusing because there are two and a half points between the bid and ask prices. You decide, correctly, to sit on your hands and watch for a better exit price closer to the opening bell. If that doesn't work, you're ready to accept your painful fate and execute a post opening fire drill.

Is Apple trading stronger or weaker than the Nasdaq-100 index futures? This simple comparison can provide actionable convergence-divergence data. A stronger Apple points to resiliency that might survive the opening downdraft, while weaker performance signals downside leadership. However, there are no perfect guarantees with a bullish divergence, and the stock might still trade much lower after the open. With this in mind, you look for a beneficial premarket exit. Any price you can live with fits this loose definition, but it's even better if you can get out near even, even though you carried a profit overnight. This "nothing ventured, nothing gained" outcome helps your mental state and gets you ready for that day's new opportunities.

Once you decide which positions to hold and which are marked for elimination, follow premarket action to see if your risk evaluation still makes sense. Quite often, early trading on your *safe* stocks will scare the heck out of you, while the most dangerous ones hold up better than expected. Many electronic crossing networks are open for business prior to 8 a.m. New York time, but most discount brokerages don't report premarket activity until that time. This systemic omission gives early birds an advantage because a large pool of traders will see nothing on their

screens until that point in time. Add natural laziness into the equation, and you have a population of sleepy buyers for your targeted stocks.

Get your selling bids out there a few seconds before this crowd joins the fray at 8 a.m. because the spark of premarket activity they generate can last just a few minutes. You'll be amazed how often you can dump positions in this time window, at or near the prior day's closing price, because many of these folks have no clue what's happening on the other side of the world. Then settle back, monitor the action, and wait for the five-minute interval leading into the opening bell. Many market players hide their intentions until this brief period, when they play a game of show and tell with the public through the market depth screen. Just keep in mind that the bid-ask spread can change radically by the open. Use any and all advantageous quotes to dump positions that approach break-even or risk tolerance levels.

Quick thinking will be needed when the opening bell finally rings and the bulk of your remaining positions gap lower with the broad market. This is the right time to ask a simple question about each stock. Does the gap drop price *into or through* obvious support levels? The relative positioning will determine your next set of trade decisions. Don't touch stocks that hold support at the open because these could bounce strongly after the initial flurry of selling pressure eases up. Heck, they might even recover and jump back into the pattern you were hoping to capitalize upon when you first bought them. Just play it safe by watching support closely, in case those levels break during the early minutes of the new session. If they do, get out immediately.

Stocks that gap through support at the open require your full attention because they can trigger shock losses if you don't make the right moves. Rather than sell immediately, observe price action for a minute and note if the stock is running lower or running in place. You have more time to act when it's just bouncing around at or near the opening price level. Alternatively, stocks running lower need to be dumped immediately. Don't get fancy and try to save pennies with a bid that anticipates a bounce. Instead, place your sell order 5, 10, or 20 cents under the market to make certain you get filled and get out.

Finally, deal with positions that hold support levels at the open. In a nutshell, some of these stocks will recover, while others are destined for lower prices. The simplest methodology with these remaining plays is to track early swing lows and then get out immediately if those levels get taken out. If you're finding it hard to think straight after several hours

FIGURE 2.4

There's no perfect solution when Apple gaps down and breaks support. The best exit may come in the premarket session or right at the opening bell, but waiting a few minutes is often a better plan. Unfortunately, that hesitation didn't work this time around because the stock continues lower for 10 minutes and then consolidates for another 10 minutes. The best strategy for traders still positioned in that consolidation pattern was to watch the tape and get out when price broke the 15-minute low.



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of damage control, just place stops under those lows and let the market have the final word.

Then get up, go outside, and get some fresh air. With the right attitude and a little luck, you could make back those early losses by the closing bell.

TWO

PART

CYCLES, SHOCKS, AND SEASONALITY

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3

C H A P T E R

REVISITING THE MARKET CLOCK

Patterns grind through endless cycles of bases, breakouts, uptrends, tops, breakdowns, and downtrends. These cycles occur in all time frames, generating all sorts of interesting alignments and misalignments between relative trends. Rather than undermining our strategies, these conflicts, collisions, and convergences yield most of the inefficiencies we refer to as trading opportunities. This crazy quilt of price development tells us that effective time management is an absolute prerequisite for long-term survival. In other words, if we intend to make money in the financial markets, we need to align our positions with all the cyclical impulses that define the endless battle between bulls and bears.

Time impacts trade management in four ways:

- By generating conflicting trends on intraday, daily, weekly, and monthly price patterns
- By defining how long it should take for price to reach a profit objective or to fail to trigger a stop loss
- By identifying relative strength and weakness cycles

- By triggering a calendar or clock bias that can override the forces of supply and demand

Calendar and clock bias, better known as seasonality, is a massively misunderstood concept that exerts a huge influence on the ticker tape. Simply stated, certain times of the day, week, and month will trigger predictable market behavior that overrules technical analysis and even common sense. For example, the daily calendar reveals all kinds of time quirks, such as turnaround Tuesday, tax loss selling, expiration magnetism, and the Santa rally. Even the intraday markets show a regular seasonal bias, with first and last hour volatility, midday turnarounds, and the 11 a.m. countertrend.

Each trading opportunity has an optimal holding period that will maximize reward and reduce risk. It's our job to uncover these magic numbers and then align positions with their strict requirements. Unfortunately, this prerequisite triggers conflict and failure when the most advantageous time alignment doesn't match the holding period anticipated in the trading strategy. Not surprisingly, this is a key factor in mediocre performance. Simply stated, your strategy and positions must synchronize properly with a multiplicity of time elements, or your trades will not work out as expected. Sadly, the majority of market players choose to ignore this requirement and just chase their tails instead of working in harmony with beneficial times and cycles.

Master the time element by aggressively managing the information interface. For starters, make sure your quote screens and databases focus on time frames that reflect the intended holding period. Then filter your charts through scans that favor certain time and cycle characteristics. Do this by adjusting the focal length assigned to moving averages and other technical indicators. With a little experience, it becomes second nature to synchronize the trade setup into a single layer of market activity. However, this is just the first step in the time management process because the interface also needs to examine relative strength and weakness from many angles. This time-sensitive component is grossly misunderstood because it's been compressed over the years into a small cache of technical indicators, like Wilder's RSI. In truth, Mr. Market gives us dozens of ways to evaluate relative strength and its overriding impact on price development.

Localize trade execution by examining the charts just above and below the time frame that yielded the opportunity. This follows the 3D charting process outlined in *The Master Swing Trader*. For those unfamiliar with that concept, independent trends on the intraday, daily, and weekly

charts generate interweaving market dynamics that will affect the outcome of the specific pattern you want to trade. Your strategy and plan need to decipher these layers of activity and gauge their relative impact on the risk, reward, and time elements of the trade. When properly executed, 3D charting analysis optimizes profit and visualizes short-term danger with amazing accuracy.

Finally, apply time-based stop losses to manage holding periods even though price-based stop losses might not be endangered. This will address the overriding impact of opportunity-cost. In other words, don't hesitate to get out of nonperforming trades when they approach the maximum time you want to be in the market. In a nutshell, this filtering mechanism recovers lost opportunity because tied up capital can then be put to work in other places.

TREND RELATIVITY

Ignorance of the time element can trigger all sorts of trend relativity errors. This concept warns that great trade setups in one time frame can lead to horrible outcomes in another time frame. Understanding this simple statement is vitally important to your survival because it will save the fortune you're losing to bad position choices. In addition, trend relativity yields two further observations that translate into extremely powerful trading strategies. First, market movement in all venues is time-frame specific. Second, all trends flow downhill, with longer-term impulses taking priority over shorter-term impulses. For example, an uptrend on the daily pattern predicts nothing about price movement on the weekly pattern. Conversely, the weekly pattern greatly impacts price movement on the daily pattern, especially when the two impulses come into conflict. This usually happens when daily price hits a key level on the weekly chart, like a swing high/low, support-resistance line, or an unfilled gap.

To avoid trend relativity errors, base your entry decision solely on charting features that might come into play during the life of the trade. You need to know your *profit target* in order to accomplish this task. This is the price level where, in a perfect world, you intend to take your reward and head back to the sidelines. It's a realistic number based on the specific pattern and the obstacles that need to be overcome within a certain time frame. You'll find these obstacles on the chart that's yielding the opportunity as well as on the chart in the next longer time frame.

Once you've established the profit target for a specific trade, go ahead and ignore all the trendlines, moving averages, and channels that price won't intersect while the position is active. Then focus your trade management squarely on the obstacles you've identified and the quality of price action when the position nears one of these zones of conflict. If you haven't figured it out yet, this is where your tape-reading skills will come into play. In addition, you'll also need to track progress on shorter time-frame charts, noting small patterns that develop at or near these nexus points.

How will technical indicators impact your trend relativity analysis? For starters, these tools lose their effectiveness when improperly time-tuned. Alternatively, resonant time readings can evoke great results with relatively simple data input. As a general rule, avoid the default settings and black boxes that come with your charting software, unless they adequately reflect your unique strategies. However, there are exceptions to the rule. For example, I've never touched the standard 20-day 2-standard-deviation Bollinger Bands that come loaded in most charting programs because they let me eavesdrop on common buy and sell signals the crowd is watching. For me, this is extremely valuable information when deciding on the most advantageous trade entry or exit.

Keep in mind that indicator time frames denote relative periods rather than absolute lengths. For example, *short term* to a swing trader denotes a different amount of time than *short term* to a mutual fund holder. As a result, your market strategies must address short-, intermediate-, and long-term considerations that are unique to your trading plan. And, yes, you're absolutely right if this effort sounds like a complex puzzle that requires a great deal of thought and intuitive problem solving.

THE ELECTRONIC TRADING DAY

The sixth chapter of *The Master Swing Trader* looked closely at the trading day, dissecting the forces of supply and demand between 9:30 a.m. and 4:00 p.m. New York time. The modern electronic markets have deeply impacted this order flow, generating an intraday environment that would look like an alien landscape to legendary trader Jesse Livermore. For the rest of us, this is the world we're forced to play in each day, whether we like it or not. Days of the week string together these individual sessions into a broader oscillation that defines expected price action in a cycle that

starts on Monday morning and ends at Friday's closing bell. Moving outward even further, weekly and monthly influences, like options expiration and the January Effect, encompass a closed system of cycles and seasonality that impacts price patterns as deeply as program algorithms or Fed meetings.

Index futures oscillations give the survivalist trader an effective method to track the buying and selling impulses that make up the market day. In addition to defining cycle length, i.e., how long buyers are in control versus how long sellers are in control, index futures also emit actionable data on the intensity of buying or selling pressure for that particular session. In general, these impulses alternate in rhythmic 60- to 90-minute cycles. Aligning these waves with specific times of day and individual equity patterns builds a wealth of data that defines short-term opportunity and risk.

The intraday shift between buyers and sellers has similarities to a sports match in which players on one team, bulls or bears in this case, take hold of the ball and try to score a few points. However, their time on offense is always limited, just like four downs or three outs, with the opposite side regaining control as soon as they've expended their firepower. The trick for traders watching this ebb and flow is to accurately gauge the relative strength of each side as they come up to bat or surrender the ball.

In other words, do the controlling team players succeed in pushing price through minor support/resistance levels, or are their efforts confined to weak oscillations that fail to "move the tape"? Key battles for the session often take place in the first hour, when there can be rapid turnover between bull and bear impulses. Expectations for significant movement drop to the lowest levels during the noisy middle of the day, when the market is often setting boundaries that will come into play in the final hour. Price action into the close may finally crown a winner and yield a short-term trend that market players are hoping will follow through at the start of the next trading day. Intraday risk taking, as well as management of open positions, needs to work in harmony with the strength and direction of these intraday impulses in order to yield the best results. Of course, there are many scenarios in which we want to use intraday weakness to buy or strength to sell. But as a general rule for a long-biased trader, cash should be raised when the selling impulse is stronger than the buying impulse and put to work when buyers prove, through their short-term power, that they're taking control of the ticker tape.

Daily cycles now start well before the New York open for American traders, as overnight impulses set the stage in the CME Globex index

futures. Early price action in the regular session is tightly focused on discounting overnight shocks, as well as establishing themes for the new trading day. The middle part of the day tests the price boundaries promulgated by these themes, while the last hour yields a print that goes into the books as the final word on short-term local supply and demand. In a nutshell, the first hour of the day proposes, while the final hour of the day disposes. About 80% of the time, the markets will move within relatively narrow boundaries defined by short-term themes, while 20% of the time, they will jolt forcefully from one price level to another in a trend event characterized by wide-range price bars. Most traders book the majority of their profits and incur the majority of their losses on these relatively rare trend days. Notably, the advent of the electronic markets on the last decade has failed to undermine the intraday oscillation between buyers and sellers or the ratio between trend and range bars.

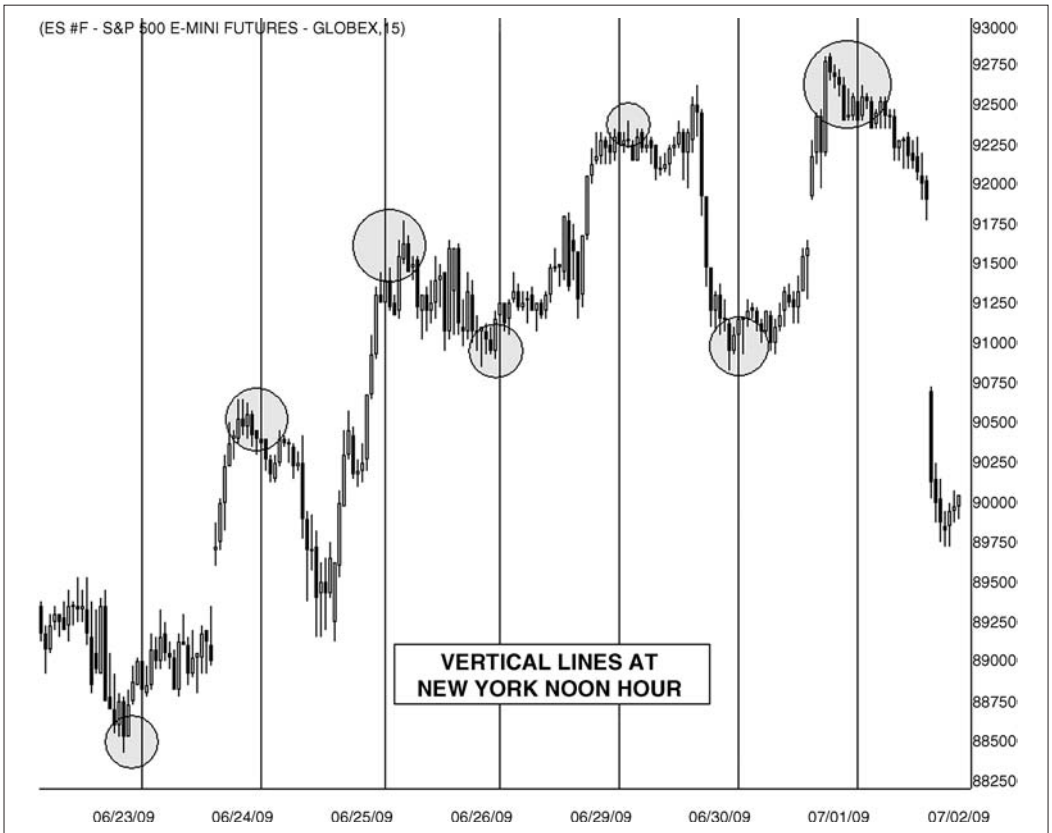
However, the trading bots have altered numerous aspects of the daily buy-sell cycle. The most critical change is tied intimately to our risk, both appetite and management. Intraday swings at all equity capitalization levels have widened considerably, which, in turn, trigger our stops more often and more violently than in the past. As I noted in the second chapter, program algorithms move like magnets toward pockets of liquidity. In the good old days, these levels corresponded with stops placed behind large-scale support and resistance, like weekly highs, lows, and longer-term moving averages. These days, millisecond execution capacity has exposed shorter and shorter time frames to stop running exercises, with the infuriating practice now encoded into dozens of program algorithms. Perhaps as an unintended consequence, stop triggering in short time frames often sets off a domino effect, cascading through longer and longer time frames until the most carefully placed stop loss has been identified and annihilated.

Intraday price action now shows a strong tendency to print high or low swings around the New York lunch hour. A typical scenario starts with a minor gap down and mild pullback after a notable rally day. The downside gathers steam for an hour or two and then fizzles out over the lunch hour. An afternoon bounce tries to fill the gap and regain the session or prior day's high. A late cycle then kicks into gear, lifting the indices above that high or triggering a program-induced selloff that tests or takes out the midday low.

Another intraday cycle actually starts prior to the opening of the regular session. Index futures often spike into a swing high or low right at 8:00 a.m. New York time, or at 8:30 a.m. if there's a scheduled economic

FIGURE 3.1

Eight days of S&P 500 futures action illustrate how opening trends tend to fade near the lunch hour and give way to proportional counterswings. Program algorithms often pause and reevaluate the playing field right in the middle of the session, prior to initiating afternoon strategies that continue their morning efforts or swing in the opposite direction. This has generated a persistent bias for the midday market to print a notable high or low.



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release. The earlier time corresponds with the activation of premarket quoting systems at the major discount brokers. In other words, the tape gets painted into a high or low for public traders checking out the early morning action. This cycle shifts forward 30 minutes on news days, often pulling into a high that triggers a selloff after the economic release or a low that yields a rally.

Ironically, the intraday markets have become more illiquid in recent years because they're dominated by phantom quotes that back away faster

than you can hit your buy or sell button. This disappearing act is most prevalent right after the opening bell. In fact, no matter how hard you've worked to establish a winning position in the prior session, chances are your profit will be placed at risk by a vanishing bid-ask spread early in the new day. This shell game eases up whenever the public is active, but those periods constitute a minority of time in the last 10 years of market history. Also consider the utter destruction of the opening bid system since the demise of NYSE specialists and Nasdaq market makers. It's not unusual these days for a Dow Industrial component to start the session with a 75 cent to one dollar bid-ask spread because no one is responsible for making an orderly market or gets an automatic advantage by adding liquidity.

CALENDAR PERILS

Traders look for directional guidance wherever they can find it. Most of the time they just react to short-term influences, like the daily flow of economic and earnings reports, but the broad market calendar also exercises considerable influence on the ticker tape. Seasonality has taken on increasingly diabolical undertones in our modern electronic markets as large institutions deconstruct classic wisdom and attempt to outthink their competition. For example, the January Effect kicked in just after Election Day for several years after the 2000 to 2002 bear market, with big rallies that left behind more cautious investors who were waiting for New Year's Day. Not surprisingly, those buying frenzies ended as soon as the traditional starting period in early January began, giving way to selloffs that targeted small-fry investors who were waiting for the classic calendar influence to move the market.

Window dressing seasonality has expanded radically from its traditional end-of-quarter influence in recent years. In prior decades, this positive bias was closely aligned with quarterly markup, when fund managers would buy the top-performing stocks of the prior three months, getting them into their portfolios just in time to report holdings to their investors. Window dressing now has a monthly impact, perhaps due to the short-term mentality that has infused every aspect of our modern markets. Performance-hungry funds now want to publish positive reports on a monthly rather than quarterly basis, so the days leading into month-end also take on a mildly positive bias. The quarterly influence remains

stronger than the monthly one, however, and has higher odds of kicking into gear right on schedule.

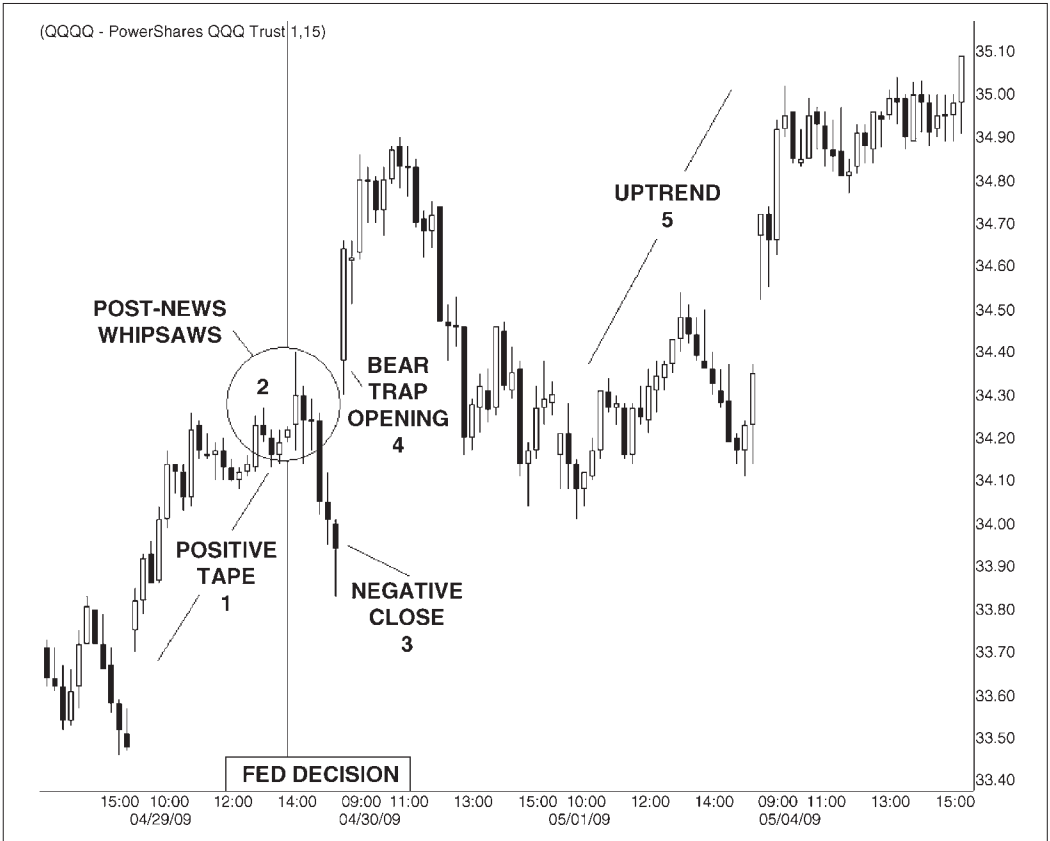
The first session of the new month continues the positive bias, with funds wiping the slate clean and picking up fresh plays for the new month or quarter. Steady rallies with few or no pullbacks characterize many of these sessions, which can be extremely profitable when traders recognize the markup early in the day and then ride piggyback until the closing bell. The period after Election Day, noted as a recent aberration of the January Effect, also has clear window dressing undertones. Think about the old adage to “sell in May and go away.” You’ll note that the advice isn’t telling us to go away *forever*. Rather, the period between June and August points to higher risk because of the thin summer tape, while September and October are notorious for tax selling pressure and historic panics. At some point, however, fund managers need to jump back into the water and book their year-end gains. The beneficial period between November and December options expiration gives institutions a perfect opportunity to accomplish this self-serving task.

Here’s how it works. These folks do a little buying and set a positive tone for the tape. This attracts the retail crowd, which salivates like Pavlov’s dog and buys the usual momentum plays. Funds fuel the fire, adding a healthy dose of options exposure coming out of November expiration. The year-end rally embers continue to burn brightly into December’s triple witching options expiration, which precedes the thinly traded period between the Christmas holiday and New Year’s Day. Funds and institutions then use the end of expiration to take profits and lock in yearly gains, with compressive options plays that won’t expire until the following year. This is why the tape often goes dead as a doornail right after December triple witching. In theory, the protective strategies will keep index prices within a narrow band that matches the final performance numbers. It’s also the time when predatory hedge funds emerge and initiate the first wave of contrary strategies that target long-side retail exposure taken in the prior four to six weeks.

The Federal Reserve, through its Federal Open Market Committee (FOMC), meets eight times per year to review and update interest rates. It can also set unscheduled meetings during dangerous times, like the credit crisis that began in 2007. Both types of meetings have become major cyclical events for the worldwide trading community. This is especially true in our Net-driven environment because the rate decision is transmitted to the public in real time, allowing everyone to place instantaneous bets on the market’s reaction. Not all Federal Reserve meetings are market

FIGURE 3.2

Trading Fed days.



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movers, but a narrow set of repetitive dynamics has been hardwired into the price action, both ahead of and after the 2:15 p.m. New York time news release. Notably, these cycles of activity haven't changed much in the last two decades, which proffers upon them almost legendary status as rock solid market influences.

Price action into a Fed decision shows a mildly positive bias (1 in Figure 3.2) with a choppy tape encouraging public traders to take on risk, even though there can be a massive disconnect between pattern development prior to and after the news. This is another example of technical analysis failing its constituency because our nifty tools just can't predict how big money will respond later in that session or throughout the week.

The general rule here is simple. Get back to the sidelines just before the announcement, or be willing to live with the consequences, which can be unpredictable. There's no need to sell or cover long-term positions into the news, but options protection can be used to dampen volatility, especially when the decision might place broad sentiment at risk. On the flip side, any position bought or sold short ahead of the release just to play the market's reaction is a lottery ticket that has no place in a mature trading strategy.

Price action following the decision routinely tracks the action-reaction-resolution cycle outlined in the second chapter. Referring back to Figure 3.2, the first or action phase (2) usually triggers a wide range surge, higher or lower, on the 15-minute index charts. This impulse may be faded two, three, or more times in the 105 minutes between the news and the U.S. closing bell. The major indices can post new highs or lows during this period, but the activity still marks the first phase. The directional impulse into the close (3) sucks in public money, routinely triggering a reversal (4) in the following session, often through an opening trap. This turnaround marks the start of the second or reaction phase, which can continue through the entire session and even the following day. Support-resistance boundaries get tested during this impulse, which, in turn, provides actionable information for the third or resolution phase (5), which is likely to start prior to Friday's close during the week of the meeting.

A moment of clarity characterizes this final phase because institutional money comes pouring into the market, and the major indices take off in a trend day that carries the indices well beyond the boundaries of the first two phases. Fighting this last phase can be extremely hazardous to your trading account. Of course, the flip side is also true. If you've done your homework and paid attention to the quality of the testing process during the second phase, you'll often have a low risk opportunity to get positioned on the right side of the market, just ahead of the emerging trend.

The challenge for traders, from meeting to meeting, is relatively simple: the pre- and post-Fed decision dynamics often kick in perfectly, but sometimes they don't. When they don't, the market usually goes through a variation of these hardwired themes rather than discarding them entirely. The trick when that happens is to look for divergences. For example, if the indices take off after the news and don't reverse as expected, that's a divergence. Or, if the market goes dead as a doornail right after the release and doesn't wake up through that session's close, all bets are off, and it's best to raise cash until the next good trade comes along.

OPTIONS EXPIRATION

Options expiration has taken on new meaning in this brave new millennium, with a full-scale death match characterizing order flow in the majority of these monthly events. Traders can take advantage of these seasonal impulses if they know exactly what to expect and are willing to wait for the best opportunities. Their first job is to identify broad sentiment heading into the Friday prior to expiration week. Start by asking a few basic questions. Are bulls in firm control? Has negativity gotten ahead of reality? Are the majority of market players euphoric, fearful, anxious, or just plain paralyzed? Next, compare the overriding sentiment with relative positioning of the major indices. In a nutshell, the strongest expiration influence occurs in strongly trending markets, when sentiment has pushed firmly into one side of the bell curve. Alternatively, a weeklong chopfest is likely when neither side controls the tape and systemic conflict keeps most players in defensive mode. In both environments, however, strongly trending stocks and futures contracts are still vulnerable to contrary and sometimes violent price behavior.

Expiration places a target on whichever side of the market is leaning too hard at the time, so bulls are at risk during broad rallies, while bears are at risk during broad selloffs. In addition, follow-through in the direction of the underlying trend is far less likely during this period. This contrary behavior makes perfect sense due to the market dynamic known as Max Pain, which tells us that stocks and indices will move in whatever direction causes the most options to expire worthless on expiration Friday. This misunderstood mechanism goes hand in hand with the attraction of magnetic strikes. Simply stated, stocks and indices will move toward price levels that attract the highest open interest. These magnets tend to occur with the greatest frequency at round number intervals like 30, 40, or 50 or at half rounds like 25, 35, and 45. This attraction can proceed gently, with a mild trend that pushes into the magnetic price, or violently, with a vertical jolt that leaves unsuspecting shareholders in a state of shock.

First and foremost, don't expect rallies or selloffs to follow through during expiration week. Nearly every move is a tease, because hidden forces are engaged in balancing their order books rather than acting or reacting to the underlying trend. In fact, the period often triggers at least one sharp rally day and an equally sharp selloff day. Not surprisingly, the net result of these volatile sessions can leave index prices at exactly the same levels they traded just before total insanity hit the tape. Also consider that each options or futures contract is tied to an underlying equity or

index, so the unwinding of one instrument has a direct and significant effect on the other. This is especially true with index and exchange-traded fund options because they represent hundreds of component stocks.

Stocks trading near 52-week highs or lows are especially vulnerable to expiration week shakeout games because these issues attract major public interest that induces lopsided call or put buying. A stock will often break out to a new high just prior to expiration and set up a bullish-looking continuation pattern. Then, despite the positive tone, it drops like a rock with little or no warning just before expiration Friday, leaving bulls with worthless calls. Flip over this price action for stocks breaking down ahead of expiration week and you'll see how put holders get burned in exactly the same way. This unwieldy magnetism warns shareholders and short sellers to use options as protective rather than speculative instruments during expiration periods. In other words, a little put protection on long equity positions and call protection on short equity positions will ease the impact of this monthly nightmare, while placing directional bets is a great way to get your throat ripped out.

Expiration week can set up excellent opportunities that take advantage of the magnetic strike mechanism. Two aggressive trading strategies, in particular, work extremely well during these periods:

- Buy between Wednesday and Friday afternoon after a strong stock sells off into a strike, or sell short after it rallies into a strike.
- Identify highly liquid stocks under or over magnetic levels early in the week, and then get on board for a trip into the magic number.

It's best when the magnet isn't situated at a new high for a strong stock or a new low for a weak stock, because that conflicts with the expiration mechanism that inhibits trending markets. The most favorable scenario in an uptrend occurs when a stock has retraced significantly off a high and is in recovery mode, posting a series of higher lows. Issues that are trading toward eights or nines, i.e., 28–29, 38–39, and 48–49, are almost perfectly positioned, with the profit target at the round number strike. Keep in mind this is an opportunistic trade. Sharp reversals often follow vertical spikes into magnetic strikes, so it's important to take your profits aggressively. One of the easiest ways to accomplish this task is to place a dynamic trailing stop, which rises or falls a fixed length behind the instrument as soon as price reaches within 20 to 30 cents of the magnetic number.

FIGURE 3.3

Strong stocks dropping into magnetic strikes during expiration week can offer great trading opportunities. Sears Holdings rallies strongly off the March 2009 low and stalls in the lower sixties at the beginning of May. The stock then drops more than 13 points in seven sessions and closes right at the magnetic 50 strike on expiration Friday. Long positions taken at the end of that session benefit from an immediate 7-point recovery rally.



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Keep track of open interest on the ETF proxies for the S&P 500, Nasdaq-100, and Russell 2000 indices rather than trying to decipher the vast array of stocks and futures contracts. These instruments often settle into the nearest round or half round number with the highest open interest, such as 30, 35, or 40. Of course, open interest is a moving target during expiration week, so a little common sense is required. Classically, the market does a *look ahead* at 2:15 p.m. New York time on the Thursday prior to Friday expiration, with those numbers pointing to the expected print for each instrument.

Midweek during options expiration is notorious for a volatile shakeout session. For years, market players expected this whipsaw to occur on Wednesday, but it now dances around between Tuesday and Thursday, perhaps as a consequence of our overly deconstructed environment. You'll recognize the event, whenever it unfolds, through intraday sawtooth and range expansion patterns on the major indices. The best plan during these dangerous sessions, unless you're a day trader, is to step back to the sidelines and wait patiently for large scale magnetic numbers to get hit, in line with the strategies outlined in this chapter.

Narrow-minded technicians face especially high risk during expiration week because they believe too intently in their magic numbers. This contrary period routinely violates support or resistance levels that will stay intact during other times of the month. As diabolical as it might sound, it isn't wise to expect a reversal during expiration week until the market does the exact thing you assume it can't possibly do. In other words, price action follows the failure dynamics that have become the status quo in our modern markets.

Triple witching is a special incarnation of expiration, taking place during the third month of each quarter with the simultaneous expiration of equities, options, and futures. Its legendary tug and pull actually starts when the index futures roll over into a new forward month on the Thursday prior to expiration week. In uptrending markets, the S&P 500 and Nasdaq-100 futures will often pull into notable lows on the day before the rollover. In this manner, long-term players can buy the forward contracts at more advantageous prices. Flip over this phenomenon in downtrending markets, with the index futures spiking into notable highs just ahead of the rollover.

Can market forces overcome expiration week influences? Of course they can. A few times each year, surprisingly persistent trends characterize expiration week action, as we saw during the Bear Stearns meltdown in March 2008. But the best analogy for this volatile period comes from classic Superman lore. Avid comic readers may recall that the Man of Steel had to face the paradox of the irresistible force meeting the immovable object. So it goes with expiration week. In other words, stocks and futures can break above or below magnetic strike numbers when enough force is applied to the system. But how much force is enough force? No one really knows the answer, but breaking the strike demands enough vigor to shake up the status quo and alter the common paradigm. That can happen at any time, as we saw with Bear Stearns, but the odds tell us it isn't likely.

One effective way to bypass expiration influence is to trade stocks that don't trade options. This limits your opportunities to small caps and about 5% of the top 1,200 liquid issues on all U.S. exchanges. A better plan is to trade lightly or take expiration week off and return to the action after the fireworks fizzle out. Whatever you do, mark your calendars in advance so this whirlwind of market activity doesn't sneak up and bite you in the backside.

To sum things up, here's a useful cheat sheet on options expiration week:

- The market's singular goal is to move equities and indices into prices that force the most options to expire worthless.
- Prepare by reducing exposure and assuming that breakouts and breakdowns will not follow through.
- Figure out early which side of the market has the biggest target on its back.
- Stocks near new highs or lows are most vulnerable to shakeout games.
- While the period impacts breakouts and breakdowns, it rarely causes a legitimate change in trend.
- Stocks and indices can break above or below magnetic strikes when enough force is applied to the system.
- Round numbers near currently traded levels usually hold the most open interest for that month.
- The triple witching clock starts when index futures roll over into a new forward contract on the Thursday prior to expiration week.
- Follow open interest in the big exchange-traded funds rather than trying to decipher the broad array of stocks and futures.
- Midweek usually triggers the most volatile activity. Be on your guard at this time, or you will lose money.
- Most shakeouts are over by the start of expiration Friday.

EARNINGS SEASON

Earnings season increases both opportunity and risk for the survivalist trader. Unfortunately, most of us get caught up in the excitement during these volatile periods and make really dumb mistakes. We also fail to take advantage of the low-hanging fruit because we become hypnotized

by facts and figures and frozen by fear of the unknown. The most potent strategy during earnings season is also the hardest one to follow if you're vulnerable to the gambling side of the trading game. Simply stated, play the stock into the minutes ahead of an earnings report, but get out before the numbers are actually released. Then examine the crowd's reaction to the report and trade back into the position when the coast is finally clear.

Yes, you heard that right, get out of the market before the company releases its earnings report. This small detail stands against the babble promulgated by analysts, in chat rooms, and on stock boards. In the real world, no one can accurately predict price action or direction right after an earnings release. This indefinable element exposes naive market players to unmanageable risk and career-ending shock losses. And, since serious-minded traders are not gamblers, we have no alternative but to step aside and let our competition play into the report and initial price swings. Of course, the majority of traders believe the market is just a roulette table on which fortunes are made picking the right numbers at the right time, but nothing could be further from the truth. Our true goal is to take risk only when it can be quantified into measurable dollars and common sense. In other words, it's always a mistake to trade when we have no exploitable edge. This is exactly the dilemma we face heading into an earnings report.

Technical analysis fails miserably as a predictor of price direction and volatility ahead of an earnings report as Figure 3.4, a violent reaction to a January 2007 release, perfectly illustrates. Knight Capital Group rallied strongly between July and October 2006. It then dropped into a well-structured cup and handle breakout pattern, with resistance near round number 20. The stock surged higher in early January, just six days before earnings, and broke out. The uptrend hit 21.70, consolidated for four sessions, and poked up to a five-year high in the session ahead of the post-market release. The chart was firing on all cylinders at the closing bell that day, with On Balance Volume (OBV), the classic accumulation-distribution indicator, confirming the breakout with a series of higher highs.

But all that good karma didn't stop the stock from falling 17% on the morning after the release and plunging through 50-day EMA support. Adding insult to injury, the prior day's high printed the top tick of the six-month uptrend and starting point of a decline that cut the stock's price in half by the end of that year. To be honest, I don't know if the company exceeded, met, or failed to meet analyst expectations. That information doesn't really matter, despite all the hype about whisper numbers and profit growth, because there's a huge disconnect between an earnings

FIGURE 3.4

Nightmare at Knight Capital.



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result and the subsequent reaction. I challenge you to argue the point, because we've all watched in jaw-dropping awe while stocks beating their numbers sell off violently or while companies confessing gut-wrenching shortfalls deliver amazing rallies. It's just another infuriating aspect of our painfully diabolical markets.

Of course, you're going to miss profits standing on the sidelines when upside surprises trigger big gaps or runaway markets. Sadly, those events will fog your brain about all the times you became the ultimate bag holder after an earnings report and were forced to hold a loser for months, just to get even. Simply stated, it comes down to pure discipline because

the big score also opens you up to the big loss. Still don't believe me? Go back through your trading records, adding up your earnings winners and subtracting your earnings losers. It's highly doubtful you're basking in the green glow of the plus column after one or two years of holding positions through these volatile events.

Meanwhile, the speculative period ahead of an earnings release offers an excellent playing field because we can use the run up or run down to ride the coattails of trader-gamblers taking unwise positions. This predatory strategy is simple. Just review upcoming release dates and pull up the most volatile issues in real time, looking for blind speculation or other inefficiencies that might yield good trades. The hit rate for this type of setup can be amazing because there's a huge amount of dumb money chasing the market around ahead of big reports. Greed and fear prior to an earnings release can persuade big crowds to bid prices into extreme levels, while insiders fan the emotional flames so they'll have better prices to buy or sell short after the news. This pre-earnings game starts about two weeks before the actual release. In a bullish scenario, look for prices to push into new highs or through resistance levels that force early short sellers to cover positions. Momentum triggered by a pre-earnings rally can last into the final minutes ahead of the release, so don't exit positions too quickly, because the laziest gamblers in the group will be checking that day's calendar and jumping into positions right near the closing bell.

Price action after the news also presents a plethora of trade opportunities on both sides of the market. We get so fixated by an earnings gap that we fail to notice most of them get filled over time, setting up better entries than available right after these reports. Of course, strategic entry a few days later requires patience and a willingness to sit on your hands until the time is right. Directional movement and volatility tend to wash out two to three sessions after an earnings report. This is an important observation. For example, a relatively solid report will often trigger three days of selling pressure as speculative positions unwind. This cleansing process should carry into, but not through, intermediate support. Look for a 60-minute basing pattern at this level, and enter the trade in anticipation of a buying spike up and through the prerelease high. Likewise, it's a bad idea to immediately sell short an earnings warning or a weak report. The initial downdraft can hit an oversold technical level quickly and yield a persistent bounce that squeezes shorts mercilessly before the downtrend finally gathers steam. A better plan in this bearish scenario is to let the bounce run its course and then sell short when the recovery pulls into a resistance level, like the opening price of the gap down day.

How should you handle long-term positions and investments during earnings season? Well that's another ball game entirely. Investors in particular can't worry about short-term price swings since the basis for the majority of their positions is fundamental, and earning gaps are part of the risk they assume. However, longer-term players can still lower volatility and reduce risk, if they choose, by purchasing options pairs that dampen the impact of sharp movement in either direction after the news.

Realistically, you're not always going to be on the sidelines when an earnings report hits the newswires. More likely, you'll get stuck trading into one or two reports each quarter because you forget to check the release schedule, or the company issues an unexpected preannouncement. Unfortunately, SEC full disclosure rules won't protect technically minded traders from big losses because they make it less likely that bad news will show up on the chart prior to the release. For this reason, it's easy to get sucked into a bullish pattern but still get crushed by an earnings warning or downside surprise.

AGGRESSIVE-DEFENSE CYCLES

The markets cycle between periods that favor rapid profit production and periods when it's hard to put a single dime into your pocket. Low-hanging fruit, public participation, and a balance between buyers and sellers characterize the aggressive phase of this cycle. Whipsaws, traps, illiquidity, and an absence of buyers and sellers characterize the defensive phase. The defensive phase tends to last longer than the aggressive phase, but there are notable exceptions, like the runaway bull market in the summer of 2003 or the runaway bear market in the late summer and fall of 2008.

Our trading strategies need to shift gears as quickly as possible when the cycle evolves from one phase into the other. Unfortunately, it's often hard to recognize this atmospheric shift until it's well under way. You have one major clue, however, that will smack you across the face and tell you "things are different." Playing one side of the cycle after the other side has taken control invariably triggers a string of losses, because your market approach stops working. Presumably, traders realize that something has changed after getting hit over the head a few dozen times by these inexplicable losses.

Trading the defensive phase effectively is more important to annual profitability and long-term survival than making money during the aggressive phase. To prove my point, look back at a bad year and notice how your losses in losing months far outweighed your profits in winning months because you were trying to outthink the market. Invariably, overtrading is the main culprit on the loss side, as frustration mounts and you feed the market beast, hoping to catch a wave or a play or anything else that fills the hole you're digging for yourself. Defensive phases often correspond with seasonal impulses, like the dog days of August, but they can occur at any time of year. In fact, when a well-telegraphed, seasonally aggressive phase like the January Effect fails to materialize on schedule, the defensive phase can kick in with a vengeance.

These periods also follow the natural strength and weakness in our trading plans. Traders are an extremely diverse group, with momentum players, trend followers, fading specialists, and scalpers all holding lifetime membership cards. Each of us gravitates naturally toward a customized strategy that matches our intellectual prowess as well as the realities of our emotional state. That's why some traders choose to sell short exclusively, while the practice sends shivers down the backs of otherwise savvy market players. Each strategy capitalizes upon narrow segments within the pattern cycle structures of individual instruments and the broader indices. Conversely, the "tweener" periods between these points of perfect alignment trigger defensive phases for that specific trader, which will persist until the next favorable segment arrives. These personalized aggressive-defensive phases can converge or diverge with larger-scale aggressive-defensive phases. With this in mind, you can understand why the greatest periods of profitability come when personal and broad-scale aggressive phases combine in a synergistic impulse. Conversely, the greatest danger arrives when a personal tweener period aligns with a broad-scale defensive phase.

T A B L E 3.1

Typical Aggressive-Defensive Phase Alignment		
Player/Phase	Aggressive	Defensive
Momentum	Runaway market	Price channel
Scalper	High volatility	Low volatility
Short seller	Downtrend	Oversold bounce
Day trader	Trading range	Trend day

SHOCK SPIRALS

Large-scale market disruptions, like the Paulson panic in September and October 2008, trigger shock spirals in which volatility spikes through the roof, price bars expand rapidly, and the broad indices surge like magnets toward large-scale support or resistance levels. Trap gaps (in the opposite direction of the prior close) and violent reversals characterize these events, which can build or destroy equity accounts in a very short time period. Traders are naturally attracted to these periods, like moths to a flame, but the majority fails to recognize the extreme risk and incurs near-catastrophic losses.

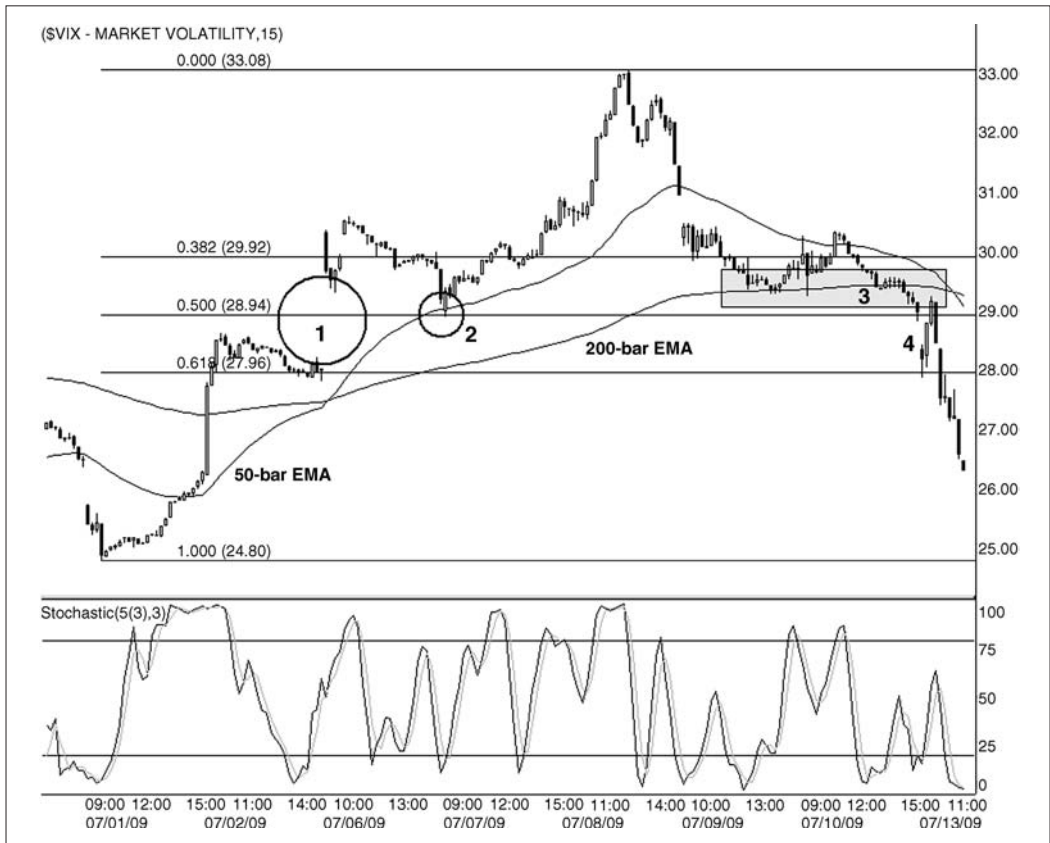
I'm an advocate for standing aside during turbulent times and waiting for the dust to settle, but the advice does a disservice to risk-conscious day traders who can book windfall profits while the world markets are careening from one volatile level to another. While price patterns caught in shock spirals routinely torture intermediate-term traders, they work extremely well in short-term and long-term time frames. In other words, 5-minute, 15-minute, and weekly charts will carve out actionable breakout and breakdown patterns during these historic periods, while chaos and risk obliterate opportunities on 60-minute and daily charts. This dichotomy is especially dangerous for swing traders who utilize one- to three-day holding periods because high volatility overwhelms the narrowly defined support and resistance levels utilized in those setups. As a result, capital preservation is vitally important for this segment of the trading population during shock spiral events.

The Chicago Board Options Exchange (CBOE) introduced VIX futures in March 2004. VIX pattern structure has improved substantially since that time, with the derivative dog wagging the tail of the classic indicator. This takes on added significance during shock spirals, when traders are placing large bets on volatility expansion and contraction. The interconnection between markets, heightened by program algorithms that trade VIX futures, generates inverse lockstep movement between VIX and the major equity indices.

Watching a 15- or 60-minute VIX chart during a crisis period is an essential element of market survival. Place 50-bar and 200-bar EMAs on these charts and line out the most obvious support and resistance levels. Then stick a 5-3-3 Stochastics under the chart and follow short-term cycles. You'll note how a VIX rally into resistance offers a good time to buy a pullback or to cover a short sale, while VIX dropping into support denotes a smart place to take a long-side profit. Act cautiously when VIX hovers

FIGURE 3.5

Use volatility patterns to track the evolution of rallies, selloffs, and shock spiral events. CBOE Market Volatility Index (VIX) takes off in a well-organized rally that corresponds with an equally powerful equity decline. Note how the indicator prints a continuation gap (1) exactly halfway through the event, bounces off the 50-bar EMA (2), and posts a high at 33.08. It then rolls over in a pullback that holds 200-bar EMA support (3) for two sessions. The subsequent breakdown (4) triggers a reliable signal to come off the sidelines and buy stocks.



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near resistance at the end of the trading day and refuses to roll over. These high pivots often signal impending breakouts, which correspond with major gap downs on the equity indices. VIX then basing at new support, after a breakout, can trigger follow-through to even higher levels, yielding a major equity decline. We saw this happen repeatedly in the fourth quarter of 2008. In a similar vein, watch closely when the storm clouds pass, the major indices move higher, and VIX drops into longer-term support, like

the 200-day EMA. A failure to bounce at these levels often precedes a VIX breakdown that triggers a momentum rally in the equity markets.

The longer-term direction of VIX is more important than the short-term price level because the indicator moves through broad cycles of expansion and contraction roughly corresponding with equity bull and bear markets. It can also drop into a sideways pattern that lasts for months or years, whether it begins at 15 or 45. These compression phases tend to correspond with base-building in the equity indices. Trend-minded traders are advised to stalk these patterns, for months if required, because the transition into the next up wave or down wave should correspond with a larger-scale bull or bear equity cycle. Not surprisingly, long-term VIX swings are intimately related to index relative strength, which I'll discuss in Chapter 12.

Trading ranges established on the major indices during shock spirals can persist for many months. Consider what happened to the Dow Industrials after the 1987 crash. The index traded to a cycle low at 1616 on October 19 and then bounced up to 2164 on October 20. It then held within those boundaries, except for one brief rally to 2193, until January 1989. This compression illustrates the massive supply and demand shift that takes place during historic market disruptions. They also set up important levels to watch, like we saw after the October 2008 crash. Although old timers might disagree, that shock spiral was far more complex than the 1987 plunge, with posttraumatic trading ranges that were easier to visualize on big liquid equities than on the underlying indices.

Shock spiral dynamics work equally well on minicrashes and bubbles that unfold on individual equities. Of course, we don't have access to specialized VIX in this smaller arena and need to rely exclusively on individual price patterns. Gap levels become critically important in analyzing these smaller scale events, which are often driven by earnings releases and other company-specific news. I'll talk more about gap strategies and intraday gap management in Part Five.

4

C H A P T E R

RELATIVE STRENGTH

Long-term profitability demands skillful market timing. Market timing depends upon four key elements: trend relativity, holding period, market day, and seasonality. Each of these factors is equally important in buying or selling at the best time and most advantageous price. Notably, it's relatively easy to be right on price or time when executing a trade, but it's very hard to be right on both at the same time. That's why getting both things right, consistently, denotes a powerful and profitable edge.

Getting the best price, but not time, forces traders into a waiting game and exposes their stops to market noise. Swing traders rely on price-based entry because the majority of their signals depend on contact with specific price levels. Opportunity-cost deteriorates over time in this scenario because capital is tied up while waiting for the trend to get under way. More importantly, the reward:risk profile mutates, so the trade you took might not be the trade you get by the time the market moves in your favor. On the flip side, getting in at the right time but not at the best price raises the odds for an immediate profit, but at the risk of an outsized loss

when you're proven wrong. Momentum traders rely on time-based entry because their signals depend on standing aside until patterns shift into trending mode. Both opportunity and cost rise to elevated levels in this scenario because the strategy routinely incurs big profits *and* big losses.

The most skillful market timer combines price and time precision, yielding trade entries at low risk levels that move immediately in their favor. This is accomplished through careful alignment with a broad and bewildering variety of relative strength cycles. It takes a great deal of experience to accurately interpret the crazy quilt of relative strength through multiple time frames and instruments, but the rewards are plentiful for the handful of traders who finally master this intricate market puzzle.

Relative strength, a.k.a. buy-sell cycles, comes in many varieties and incarnations. Trade management demands intimate knowledge of this bipolar energy, so it's urgently important that we incorporate as many variants as possible into our daily routine. While Stochastics and Wilder's RSI form the popular core of these technical tools, there are literally dozens of methodologies and processes to gather this type of information. For example, every market day generates a list of outperforming and underperforming sectors. Sorting these groups by percentage gain and loss generates a relative strength snapshot that tells traders what to buy, what to sell, and what to avoid during that specific session.

Buy-sell cycles are continuous, often repeating in regular intervals that can be predicted with incredible accuracy. To complicate matters, these cycles evolve through all time frames, generating a plethora of strategic convergence-divergence relationships. While most traders find the interpretation of these interweaving cycles to be a daunting task, the smart ones realize it's a meal ticket upon which an entire career can be built.

Relative strength cycles provide continuous feedback, which means it's foolish to limit data gathering to narrow intervals, popularly known as crossovers and overbought-oversold signals. Each tick of relative strength depends upon convergence-divergence mechanics because it's built on a comparison between two market-related numbers. Analysis is then extended over time to generate a flowing graph, percentile rank, or leadership list. Taken in sum, relative strength exposes the endless battle between bulls and bears and tells us which side is in control of the tape at a specified point in time.

All trading strategies rely on relative strength interpretation. It's a big subject because the market is chock full of cycles, each capable of controlling price action at a moment's notice. While it's impossible to track every oscillation, we must take notice when relative strength has the

power to affect our positions. To accomplish this task, place a 5-3-3 Stochastics under each chart on your trading screen and manage watch lists with a database tool, like the Price vs. 200-day EMA sort. Complete your relative strength toolbox with a smoothed (14, 7) Wilder's RSI that captures monthly cycles and an ETF/sector list that tracks daily percentage gain/loss in real time.

THREE RELATIVE STRENGTH TOOLS

Stochastics tracks the flow of buying and selling pressure in all time frames. This cyclical alternation, from overbought to oversold and back again, is akin to a ball game in which one side is given the opportunity to score but must use its time wisely. It's our job to sit in the stands, watch as this game unfolds, and take predatory advantage of the losing side. This is especially true in the intraday markets, where index futures emit buy-sell cycles in regular 60- to 90-minute intervals. There's no need to trade these cycles directly. Rather, they work in tandem with the opportunities we've already identified for that session, telling us the most favorable times to buy, sell, take profits, or take losses. In addition, convergence-divergence relationships between index patterns and their Stochastics cycles add predictive power because we can use the information to measure which side of the market is winning or losing that day's biggest battle.

The Stochastics cycle of the individual setup generates a convergence-divergence relationship that tells us whether the favored stock, futures contract, or currency is relatively stronger or weaker than the underlying indices, at least for that session. It also indicates whether the instrument's buy-sell cycle is moving ahead of, in sync with, or behind the broader market. By itself, this piece of data supports a myriad of trading strategies because it can uncover setups that will move higher or lower with the indices but are acting on a time delay because their cycles haven't turned yet.

Stochastics represents the classic overbought-oversold oscillator. Unfortunately, most traders don't understand how to correctly interpret the valuable information it provides. For example, the worst thing you can do is to jump ship when Stochastics hits a high or low extreme because the most reliable profits are booked in the early stages of an overbought or oversold market (above the 80 or below the 20 line). Instead, use simple double top or double bottom patterns to pinpoint reversals driven

FIGURE 4.1

Stochastics double top breakdowns trigger reliable sell signals. Research in Motion rallies more than 15 points in a month and tops out above 85 in June. The last phase of the uptrend curves out a lower high (1) on Stochastics, which breaks to the downside (2) just two days later. A short sale entry on the failed bounce (3) into the gap in the following session would have netted an excellent profit.



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by overbought or oversold conditions. The best signals unfold when Stochastics makes a lower high (or higher low) near the 80-20 line and then expands in the opposite direction. This type of pattern will often trigger an entry or exit signal just ahead of price movement and should be acted upon without further confirmation.

Realistically, it doesn't matter which Stochastics settings you choose because the indicator will print valid patterns with any set of inputs. As noted in *The Master Swing Trader*, I favor a 5-3-3 setting, which I apply to all time frames. Different inputs will emit similar cycles but will vary in

the level of market noise. The wisdom here is to match your settings with your trading style. For example, day traders capitalize on subtle shifts in market direction, which can be visualized more clearly using my shorter-term settings. On the flip side, the longer-term setting of 14-7-7 will help position traders to hold firm through endless whipsaws and shakeouts.

Stochastics can't help us if we choose the wrong stocks to trade in the first place. Our carefully managed watch lists need to turn out profitable candidates that align with the most active pattern cycles which, not surprisingly, also mark out major relative strength cycles. To this end, traders need to build stock lists with data sorts that identify the strongest or weakest opportunities. The Price vs. 200-day MA sort offers a powerful tool for relative strength examination. You'll find the long side of this output overlaps with the popular IBD 100 list from *Investor's Business Daily* but uses no fundamental data. It can also be updated on a daily basis to find out what's hot and what's not in that particular market environment. Traders using Worden TeleCharts are familiar with this technical sort because it's been part of that product for almost two decades, but other software can easily accommodate this simple relative strength formula.

The TeleCharts version uses percentile rank vs. the entire stock market. Since that involves calculus, I'll stick with the simpler raw value, which will sort just as easily.

PRICE VS. 200-DAY MA (EMA PREFERRED)

Formula

$$((C - 200\text{-day MA}) / 200\text{-day MA}) \times 100 = \text{percent above/below the 200-day MA}$$

Example #1: A stock closes at 45, with a 200-day MA at 40.

$$((45 - 40) / 40) = .125 \times 100 = 12.5\% \text{ above the 200-day MA}$$

Example #2: A stock closes at 35, with a 200-day EMA at 40.

$$((35 - 40) / 40) = -.125 \times 100 = -12.5\% = 12.5 \text{ below the 200-day MA}$$

It's too much work to sort the entire market, so filter your list with formulae that limit output to stocks near 52-week highs for a strength list and 52-week lows for a weakness list.

Filter (strength)

$(1 + [(C - 52\text{-week high})/52\text{-week high}]) \times 100 = \% \text{ of the 52-week high}$

Example: If a stock closes at 50, with the 52-week high at 60.

$(1 + [(50 - 60)/60]) = (1 + [-.17]) \times 100 = 83\% \text{ of the 52-week high}$

Filter (weakness)

$(1 + [(C - 52\text{-week low})/52\text{-week low}]) \times 100 = \% \text{ of the 52-week low}$

Example: If a stock closes at 35, with the 52-week low at 30.

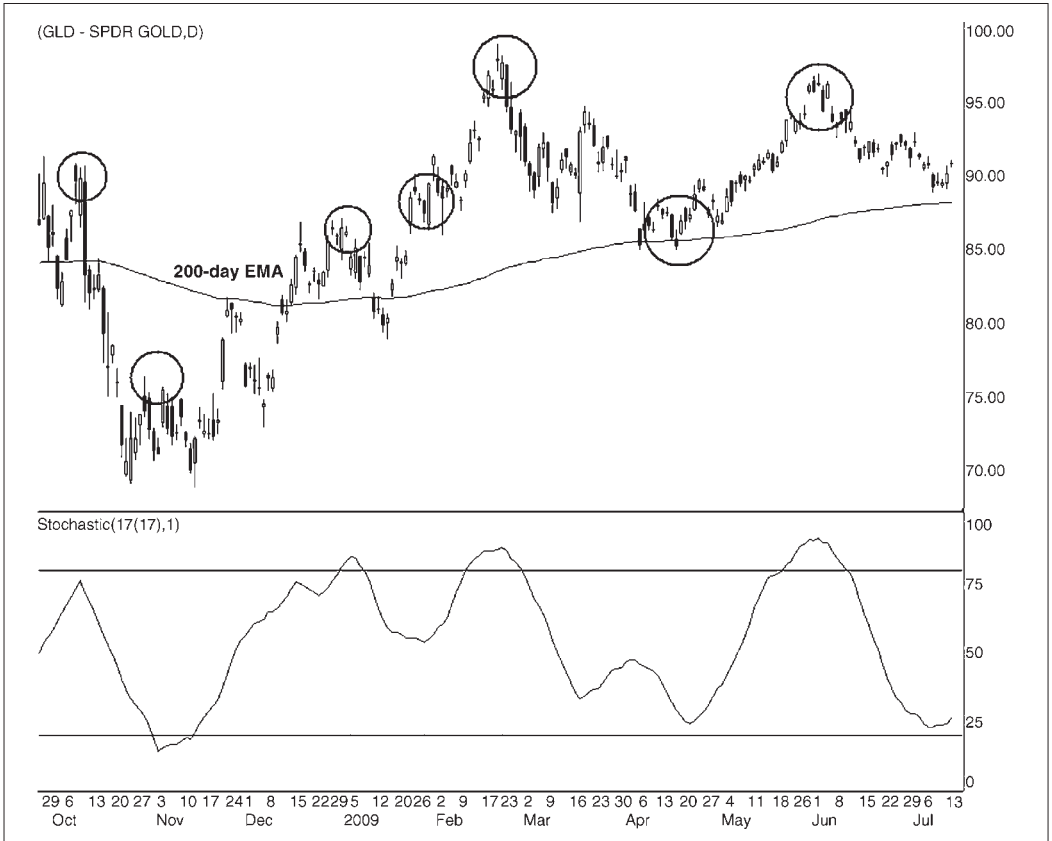
$(1 + [(35 - 30)/30]) = (1 + [.17]) \times 100 = 117\% \text{ of the 52-week high}$

Run the 52-week high or low scan first, creating a list that contains just stocks in the top 25% for a strength list or bottom 25% for a weakness list. Run this list through the Price vs. 200-day MA scan, and your work is done. Scanning output in both directions reveals active momentum plays rather than pullbacks or narrow range setups. Also keep in mind these scans are just a starting point because you'll still need to stalk the most promising candidates and wait until they grind out favorable patterns and low-risk entry points.

Long-cycle indicators fill out a versatile relative strength toolbox. I prefer a 14-day Wilder's RSI, smoothed by 7 periods, but many real-time quoting systems don't let you smooth this classic indicator without playing with their custom formula functions. So, if you're not adept at program language, I recommend an ultra slow 17-17-1 Stochastics as a substitute. Slow moving relative strength indicators highlight buy-sell swings in the lunar or monthly time frame. Although nonastrologers might disagree, the financial markets tend to oscillate in 21- or 28-day cycles of strength and weakness. The best long-side opportunities for position trades tend to appear at the bottom of this cycle, while the best short sales come at the top. A longer-term relative strength indicator exposes these turning points early in a new swing, often before price confirms the reversal through an index breakout or breakdown.

FIGURE 4.2

Use longer-term relative strength indicators to identify swings in weekly and monthly cycles. Although not perfect, 17-17-1 Stochastics pinpointed the majority of major turning points in the SPDR Gold Trust ETF between October 2008 and July 2009. That's a fantastic record, considering this period marked one of the most volatile trading environments in the last 20 years.



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In addition to marketwide relative strength, individual stocks, futures contracts, and currencies also tend to oscillate in regular time intervals. For example, when you see a series of 21-day downswings on Apple or Research in Motion, expect a 20- to 22-day downswing the next time that long-term relative strength rolls over from the overbought level. This is incredibly valuable data in trade management because it facilitates reward and risk targeting as well as supporting a plethora of early entry strategies. Long-cycle indicators also act as primary filters at major turning points, both in the major indices and individual stocks. Emotions

run high after long rallies and selloffs, with the airwaves and Web world dominated by weak-handed opinions driven by greed or fear. Long-cycle relative strength filters out mindless chatter during these periods, telling the survivalist trader whether the ticker tape supports or refutes the emotional table pounding.

Avoid long positions when the long-cycle indicator is pressed above the upper line and turning over because the downturn may signal a decline lasting for six to eight weeks at a minimum. Alternatively, you can often time new entry with great precision after stocks have fallen to support, gone limp, and the long-cycle indicator turns higher from the oversold line.

READING THE BUY-SELL SWING

Relative strength and weakness expose the buy-sell swing. In the real world, there are a finite number of buyers and sellers for a single financial instrument at any point in time. Whenever this supply-demand equation gets out of balance, the buy-sell swing emits actionable data by carving out cyclical peaks and valleys. In the simplest terms, it's how markets get pushed into overbought or oversold technical conditions. Once dislocated, these forces move back into balance when one of two things happens: (a) supply is replenished on one side, or (b) demand is depleted on the other side. From the trader's viewpoint, this equation is vitally important for two reasons—long positions take on increased risk in an overbought market, while short positions take on increased risk in an oversold market.

The trading strategy utilized to enter and exit positions must align with relative location within this buy-sell cycle. In other words, buying weakness in an oversold market makes sense, while chasing the downside is foolish. Alternatively, loading up on hot stocks in an overbought market is a good way to get clobbered, while taking long-side profits reduces risk. Cycle length complicates the trader's process of alignment because the buy-sell swing exists in many time frames. For example, there are major oscillations that follow the monthly calendar as well as 90-minute impulses driven by the index futures. Effective management of these cyclical variables separates the mediocre trader from the truly outstanding performer.

Traders need to know which buy-sell cycles are at work at a given point in time, even if they don't understand their origins or persistence.

To accomplish this task, use a 5-3-3 Stochastic to track daily oscillations lasting four to seven days and 60-minute oscillations lasting five to ten hours. The 60-minute version works extremely well in pinpointing the two- to three-day buy-sell swings that characterize a typical five-day trading week. This is perhaps the most important cycle for swing traders to understand because their livelihoods depend on it.

In Figure 4.3, Celgene oscillates higher and lower in a narrow trading range over a two-week period. At the same time, 5-3-3 Stochastics swings back and forth in half-cycles that measure between three and eleven hours. A few of these swings trigger wide range movement, while the rest of them yield little more than directionless noise. In all cases, though, you

FIGURE 4.3

Celgene swings.



can see which side is at bat and which side is playing the field, trying to keep runs from being scored. Finally, note how Stochastics oscillations that hit overbought or oversold levels tend to trigger longer lasting counterswings than those that reverse in the middle of the indicator's range.

Now consider this common scenario: A stock rallies into a closely watched breakout level, noses above resistance, and then reverses sharply. Invariably, the buy-sell swing on the 60-minute pattern then shifts to the downside, with sellers in firm control. These folks now have one to one and a half days (five to ten hours) to push prices lower and break a few more support levels. Other traders flip to the chart because it's just turned up on a breakout or relative strength scan. However, the Stochastics rollover indicates that it's time to stand aside and just watch the setup. The sell swing carries through into the next session with a lower opening, followed by a narrow sideways pattern. This compression causes the buy-sell swing to shift back to the buy side, signaling that a short-term low has finally been struck.

Sidelined traders now have an opportunity to reconsider the breakout trade. They examine the price pattern for clues about the strength or weakness of the impending buy swing, with the pullback's depth providing the focal point of the analysis. If the stock is ready to break out "for real," it will often print a relatively high pivot on the final downswing, with price holding above the 38% retracement of the last upswing. In addition, the upturn will start at or above an intermediate moving average, like the 50-bar EMA. With these types of data in hand, more aggressive traders scale in, while more conservative traders wait it out and buy after price rallies above the high of the last upswing.

Of course, trade entries don't always work out as expected because relative strength indicators can hit one extreme or the other and just stay there for extended periods. In addition, conflicting market cycles, or cycles that stick around too long, will force traders to buy too late or sell too early on a regular basis. In the final analysis, it comes down to performance over time—i.e., does trade alignment with the buy-sell swing make or lose money over time? Frankly, this misunderstood tool can enhance your bottom line dramatically and give you something to think about during the trading day aside from what market gurus are saying or what other players are doing with their money.

This points out yet another advantage of utilizing the buy-sell swing in your daily workflow. Successful trading requires detachment from the endless market noise. The best way to gain this inner authority is to have an archetype for market structure, like pattern cycles and

the buy-sell swing, so ingrained into your fevered brain it can overcome the siren call of nonsense that flows out of Wall Street and the financial media.

IDENTIFYING REVERSALS AND COUNTERSWINGS

Most of us can trade well when the market is moving in one direction. The problem starts when price action reverses, and we have to decide whether to hold on, lighten up, or get out of our open positions. The skill in recognizing which path to take when the ticker tape stops cooperating often means the difference between a healthy profit and a painful loss. In a typical scenario, we buy with the intention of holding a stock for a few days or weeks. We've done our homework, and the first move goes in our favor, as expected. We're now enjoying a small profit and feeling pretty good about our trading expertise. However, we're also sitting ducks because the market moves in continuous waves of trend and countertrend activity. In other words, for every notable action, there's usually a notable reaction. This two-sided mechanism provides a diabolical method to shake traders out of good positions before they get the chance to pocket their hard-earned gains.

Learn to anticipate counterswings before they happen. This foresight will give you more time to measure the danger and to execute an appropriate response. In this regard, here are 10 ways to identify reversing markets before they turn your winners into losers:

1. Look for daily trends to reverse after three bars in either direction. This follows the classic strategy outlined in *The Taylor Trading Technique*, published in 1950.
2. Wrap Bollinger Bands around your bars, and watch for spikes that pierce the top or bottom band by more than 75% of the bar's length. This thrust signals a market that will likely reverse in the next one or two bars.
3. The odds for a reversal increase on Tuesday, especially after a trend carries over from the prior week. Reduce risk by dumping positions into that day's open. Better yet, get out Monday afternoon and save yourself the trouble.
4. More reversals take place after a financial instrument hits a new high or low than at any other time. In swing trading lore, these

are called “2B reversals,” a phrase coined by Victor Sperandeo in his 1991 book *Trader Vic: Methods of a Wall Street Master*.

5. Volatility usually stalls ahead of a reversal. Watch out for markets that stop going up or down and then congest into tight trading ranges.
6. Beware of a high volume blowoff. A market will reverse as soon as everyone who wants to buy or sell comes off the sidelines and gets into the action.
7. Drop down a time frame and look for reversals in the shorter-term patterns. These tops and bottoms flag potential turnarounds in longer-term time frames.
8. Get familiar with classic candlestick reversals. Look for hammers and dojis at key support or resistance. Watch out for dark cloud cover after a big rally. Stay alert for a harami reversal after a big bar in either direction.
9. Rallies and selloffs tend to occur in threes before yielding to major reversals. Each primary wave should be separated by a pullback or congestion phase. The last wave tends to trigger the most technical divergences.
10. A big gap against an active trend, known as a hole-in-the-wall, signals that direction has changed in a single bar. Don't wait for confirmation when the instrument gaps the wrong way and doesn't fill before the closing bell.

IDEAL TIME VERSUS IDEAL PRICE

As I noted earlier in this chapter, there's often a conflict between price and time. For example, the market gives you a perfect price to go long or short but then forces you to wait longer than expected before the position eases into a profit. Or, you find a great setup that's already moved off a tradable low, forcing you to enter at a greater point of risk. Traders tend to become hardwired to just one of these two alternatives, so you need to know which will align best with your unique market approach.

Don't underestimate your emotional baggage when the hunt for the perfect price steps into a high volatility environment. Buying the dip in a falling market demands a strong stomach and a positive attitude, while selling short in a rising market can induce floods of paranoia and

self-doubt. Frankly, the majority of traders can't handle the mental burden that comes with either of these countertrend price-sensitive strategies.

At the other end of the spectrum, perfect timing requires continuous stalking of potential trades to ensure that entry signals don't get overlooked. Get up to make a sandwich or walk the dog, and you can easily miss the most profitable opportunity of the day. Average loss will also be greater in a time-sensitive strategy, because logical stops need to be placed farther away from entry points. In addition, this approach wrestles with the elusive concept of opportunity-cost. Realistically, many of our perfectly timed entries will be misfires in which the instruments just chop back and forth, failing to pay off. The profitable swing, when it finally comes, will also be weaker than expected in many cases, earning a little cash for the trader but failing to bring in the big bucks.

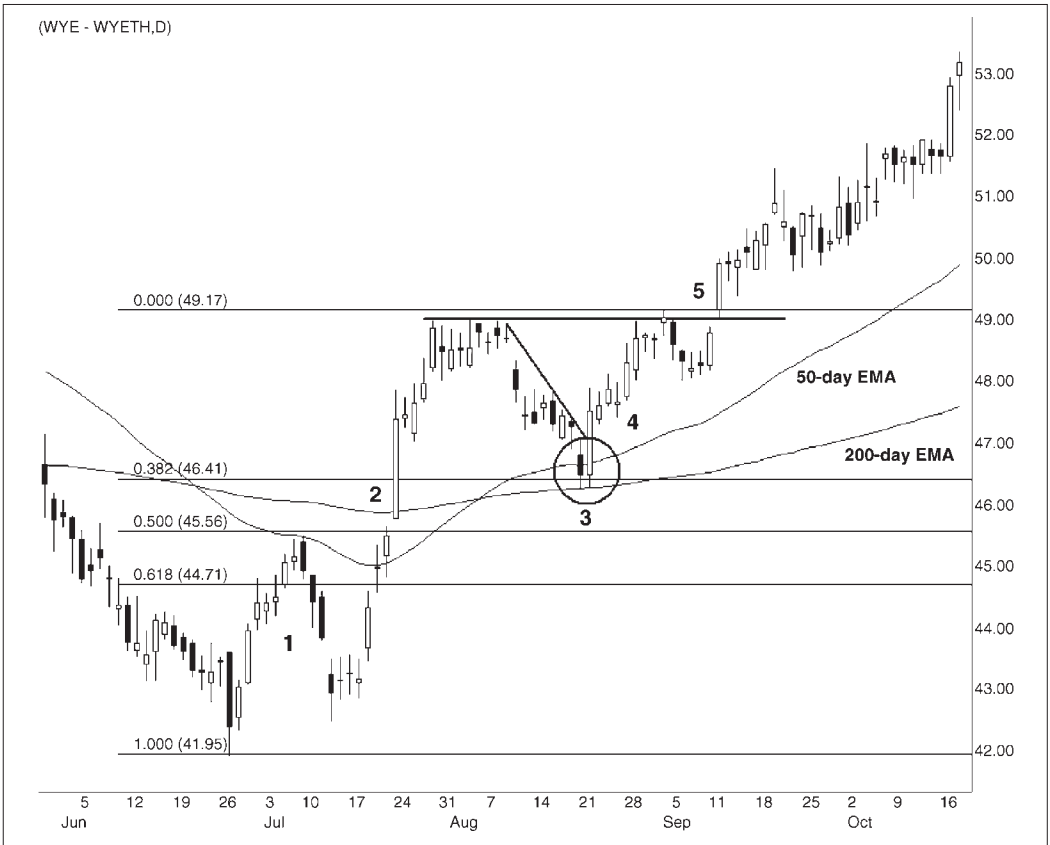
To sum up, trading by price reduces risk but requires more patience. Trading by time takes higher risk in hopes of a faster profit. Let's see how this works with two examples.

In Figure 4.4, Wyeth posts a double bottom pattern (1) near 42 and starts to head higher. It rallies above the 50 and 200-day EMAs (2) in July and surges to 49, where the uptrend runs out of gas. Traders who missed the rally watch the subsequent pullback for a buy signal that gives them a second-chance opportunity. The ideal price comes when the stock breaks six-day support and gaps down into the moving averages (3), which also marks the 38% retracement of the June into August rally. Price surges higher in the following session, breaking a two-week down trendline and filling the gap (4). This buying spike triggers the ideal time to enter the trade, even though it's a point above the ideal price entry. A second ideal time arrives a few weeks later when the stock completes a month-long inverse head and shoulders pattern (5) and breaks out above 49.

Each time- and price-based entry signal works like a charm in this example. The selloff ends exactly at moving average support, the trendline breakout yields an immediate price surge, and the inverse H&S breakout triggers a wide range rally bar followed by a steady six-week uptrend. Of course, many things could have gone wrong with both price and time. In the real world, the decline didn't have to stop at support, the trendline breakout could have failed, and short sellers might have faded the inverse H&S breakout. Those common risks warn us to utilize aggressive trade management techniques whether our entries are time or price based. You're right if this sounds like secret code for placing a stop loss as soon as

FIGURE 4.4

Wyeth pullback.



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positioned and then following the tape to ensure that price action follows your expectations.

The Applied Materials rally in Figure 4.5 illustrates just about everything that can go wrong in a price- versus time-based strategy. Things start out well enough when the stock breaks above 200-day EMA resistance at 17 (1) and then pulls back to test the moving average (2), signaling a price-based entry. It breaks down for one day and then surges higher, triggering a “failure of a failure” buy setup, which offers a nearly perfect time-based entry. Price consolidates for five sessions near the rally high and then breaks out (3), issuing another time-based entry. A few weeks later, the rally stalls out, and the stock sells off into the convergence (4)

FIGURE 4.5

Applied Materials whiplash.



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of 50- and 200-day EMA support. This natural buy level yields 12 days of whipsaws that trigger one false signal after another. Finally, price pulls out of the chaos (5), triggers another time-based entry, and rallies up to 19. Everything then falls apart once again, giving way to another month of stop killing volatility.

The chaotic price action when the stock dropped into support warned traders to get out immediately and move on to another opportunity. Unfortunately, our natural impulse is to keep throwing money at whipsaws, hoping that something finally “sticks.” This self-defeating persistence illustrates the high level of discipline required to execute a profitable price- or time-based strategy. In a nutshell, the trade outcome depends on

specific tape behavior associated with perfect price or perfect time. Market movement that strays from your expectations yields a notable divergence that needs to be measured for its impact on reward:risk and used as an excuse to exit the trade if required.

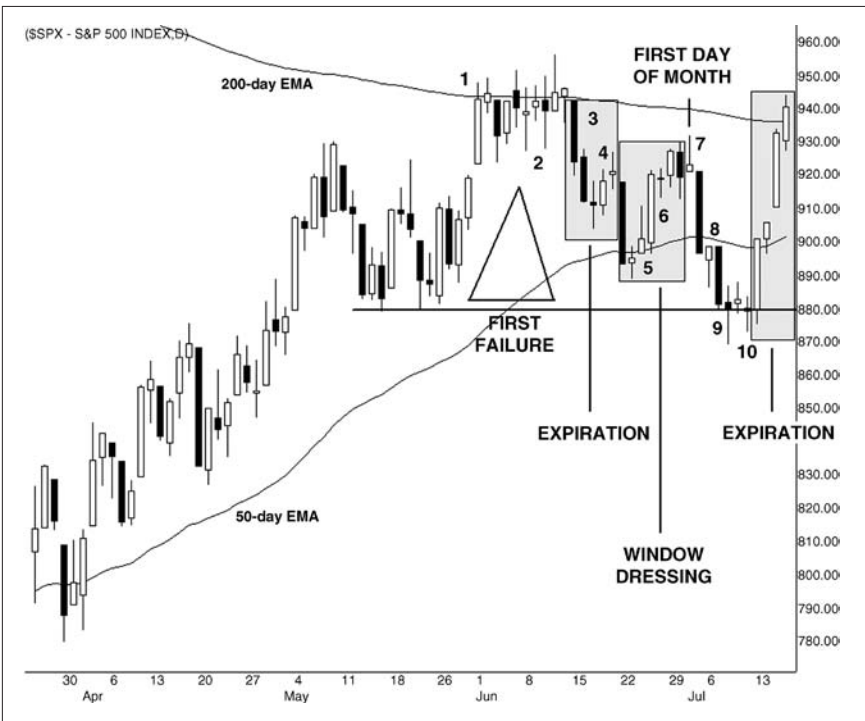
THE REAL WORLD: READING BETWEEN THE LINES

It's the third week of June, and simple technical analysis isn't giving you all the answers you need to make the trade.

In Figure 4.6, the rally off the March 2009 lows had made significant progress by the beginning of June, when the S&P 500 finally struck

FIGURE 4.6

Calendar events overrule supply and demand.



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the 200-day EMA from below (1). Resistance at this line in the sand then kicked into gear, stalling the upside and dropping the index into a two-week sideways pattern (2). Bullish analysts were tripping over themselves at that time, pounding the table about the major recovery and predicting that higher prices would soon follow. The index then dropped out of the trading range on June 15 (3), which happened to be the Monday of triple witching options expiration. Selling pressure continued through Wednesday, with a small bounce into expiration Friday (4). In hindsight, the expiration selloff made perfect sense in light of highly bullish sentiment that anticipated the immediate resumption of the three-month rally. In other words, overeager buyers had big targets on their backs during expiration, with Max Pain dynamics kicking into gear and ensuring that bullish call positions expired worthless by Friday's close.

Sellers took control after the weekend, generating a two-day decline that dropped the S&P 500 index through the 50-day EMA and into a four-week low (5). Revitalized bears were now hoping to draw blood, with the index down more than 5% in the prior week and the downdraft undercutting moving average support. However, they had forgotten to take a deep breath and a long look at the calendar. As it turned out, the selloff had run into positive seasonality, generated by end of quarter window dressing. In other words, the deteriorating technicals might have to wait while institutions scooped up a basket of top-performing stocks in an effort to massage their quarterly performance numbers. Who needs fundamentals or technicals when a sales pitch and a big bonus are at stake?

It would also have been a great time for bears to consider a few aspects of window dressing that far outweigh the price charts:

- The event comes out of nowhere, so it's often futile to pay attention to momentum indicators and use them to manage trade decisions.
- Markup doesn't care about price positioning, so a moving average or a trendline won't stop the speeding train.
- It affects a random selection of stocks, with a number of powerful rallies and a broad basket of small gainers.
- The influence peaks on the next to last trading day of the quarter, even though the financial media generally ignore the event until the final monthly session.
- Price action will show few pullbacks, if any, during markup rallies, denying easy entry to latecomers and disbelievers.

- It's often a one-day affair that disappears as quickly as it begins, but price holds onto its gains into the new month.
- The first session of the new month continues the positive influence, with the same institutions picking up favored plays for the new quarter.
- Sentiment turns sharply to the negative on the second trading day of the quarter as supply and demand resume control of the tape.

Staying with Figure 4.6, the S&P 500 turns the corner at the 50-day EMA, perks up, and takes off in a 2% rally on the fourth trading day (6) prior to quarter's end. The positive vibes continue for a few more sessions, but the index makes little further progress. A funny thing then happens. The index ticks higher through the first hour on the first day (7) of the new quarter but then turns tail and closes near its daily low in a harami reversal. Observant traders correctly recognized this was a bearish divergence because a positive seasonal influence had failed to show up on schedule. In fact, convergence-divergence relationships between seasonality and expected price behavior are just as powerful as chart-driven relationships and just as predictive of short- to intermediate-term market direction. In this case, the failure of the market to rally *when it was supposed to* issued a warning signal that sellers were getting ready to retake control of the ticker tape.

This bearish scenario unfolded in the next session with a nasty selloff that dropped the index back under round number support at 900 (8). The ugly close below the 50-day EMA revived battle-weary short sellers, bringing them into the market and triggering more downside in the next three sessions. The third selloff day violated six-week support at 880 (9) and completed a bearish first failure pattern, which marks the first 100% retracement of a prior rally wave. In addition, many exchange-traded funds carved out ominous looking head and shoulders patterns that broke down in the two sessions after the S&P 500 completed the downswing. Indeed, the bearish dominoes were falling, one by one, with the broad market setting up for a major correction. But for the second time in a month, short sellers forgot to keep one eye on the calendar and the other on the exit button.

The second consolidation day after the selloff (10) also marked the Friday before options expiration. With bearish sentiment taking firm control after the weeklong decline, short selling and the put/call ratio were escalating rapidly. In other words, bears had just placed major targets on their backs heading into expiration week. No, figuring out which side of the market will get targeted during expiration isn't rocket

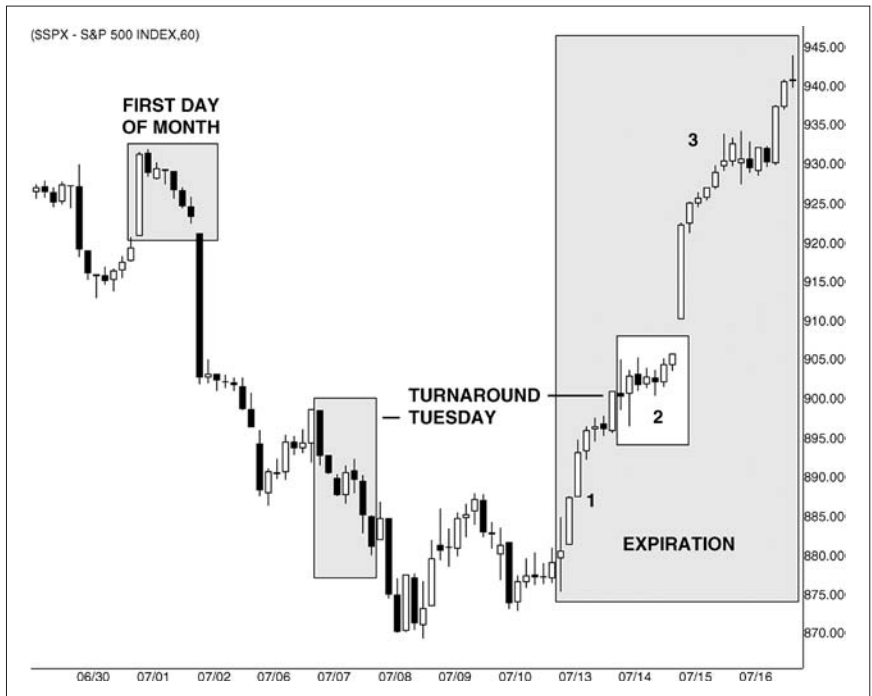
science. All that’s needed is a reality check of the unpleasant feeling in the pit of your stomach heading into the first day of the week. Are you afraid the market is falling apart and your long positions will bury you? Are you upset because you’re not long enough and convinced the market is headed for a moon shot? Flip over this soul-searching if you’re net short.

There’s little argument that short sellers are a nervous bunch who are overly sensitive to every ripple of the ticker tape, scared to death they’re staring at the first wave of a major squeeze. Ironically, that’s exactly how they should have felt on the morning of Monday, July 13, the first day of expiration.

Figure 4.7 illustrates how the market took off like a rocket that day (1), squeezing short sellers into oblivion. The head and shoulders patterns didn’t help, as one exchange-traded fund after another remounted

FIGURE 4.7

Expiration short squeeze.



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its broken neckline and lifted out of obscurity. Adding insult to injury, the S&P 500 rally never stopped at 50-day EMA resistance, which is a natural turning point and entry level for new short sales. Calendar-observant traders had a great opportunity to predict this unusual slingshot in advance. Monday's rally had been powerful, but turnaround Tuesday had the power to drop prices back under the moving average and give short sellers another chance to pull down the market. However, note how sellers failed to turn the ticker tape that day (2), despite a first hour downdraft. The slow-motion recovery into the closing bell signaled a bullish divergence because the index didn't reverse on a seasonally favorable day to reverse. Yes, this is the exact opposite dynamic of bearish price action on the first day of July. More importantly, it yielded an actionable signal that the rally out of nowhere wasn't done yet. The broad market then took off in two more trend days (3), posting highly bullish 90:10 up:down volume readings on both major exchanges.

In the market's diabolical way of doing things, the summer correction anticipated by so many technicians and analysts had turned quickly into a major breakout, helped along at every turn by overriding seasonal influences that overruled tape action, technical analysis, and common sense.

THREE

P A R T

REDISCOVERING PROFITABILITY

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5

C H A P T E R

THE NATURE OF WINNING

Let's talk about the differences between profitable and unprofitable traders. Is it a question of experience, or are some folks just born with the talent to play the financial markets successfully? How does risk tie in with profitability, and are profitable traders more or less willing to make riskier trades? Trading psychologist Mark Douglas talks about the three stages in becoming a profitable trader. First, you learn how to find promising setups. Second, you learn how to enter and exit those positions at the right time and at the right price. Third, you get to a level of experience where you build equity on a consistent basis. Ironically, the secret to this third step is really no secret at all. You just master the discipline required to follow your methodology, system, or plan.

Traders need to make an important choice between two equally attractive alternatives early in their careers. Neither approach is right or wrong, but both paths of action demand a ruthless focus on the profit and loss feedback loop.

1. Follow a specific methodology that forces you out of the market during adverse conditions.
2. Master a broad range of skills, and shift strategies as market conditions change.

Unprofitable traders rely on a poorly matched execution style or a good one they haven't mastered yet. In most cases, they've failed to recognize critical errors in their methodology because it was learned in a book or through inappropriate conditioning, like making money on bad decisions. Conversely, profitable traders know all the weak points in their broad toolkit of strategies and exercise damage control at all times.

You can't understand your trading methodology until you analyze profits and losses over long periods. Locate systemic weaknesses as quickly as possible, and then decide if your methodology, system, or plan really works at all. In the real world, many traders discover their entire approach to the markets isn't right for their lifestyle, emotional nature, or long-term goals. For example, you might be a scalper with the disposition of an investor, or a day trader who hates volatility. The bottom line: bad things will happen when your system doesn't match your personality.

Nassim Taleb offers a powerful argument about why we lose money in his controversial book *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets*. The author alleges that many traders think they're gunslingers because they were in the right place with the right strategy for that moment in history. Unfortunately, these so-called experts wash out of the markets as soon as times change, because their foolproof strategies crash and burn. Does Taleb's argument sound familiar to you? It should because it zeroes in on the bull market genius that evaporated after the tech, real estate, and energy bubbles burst. Now here's the real question: Why do you still chase stocks in the same way you did two, five, or ten years ago? I guess the obvious answer is, you want to believe those days are coming back and are willing to sacrifice your hard-earned capital over and over again to relive those glory days of endlessly rising prices.

Nearly every poll taken during adverse market conditions yields identical results. About half the respondents will indicate they're thinking about leaving the game, because they're getting clobbered, while the other half tells pollsters they're booking the best profits of their careers. To which group do you belong in tough times? Well, I can answer that one for you. If you're adapting to the market, seeing what's right in front of your nose, and not allowing old habits to interfere with reality, you probably do very well. But if you're praying for better days or playing a bull market game

in a bear market world, chances are you're getting crushed like a bug on a windshield.

Volumes have been written about money management techniques, like evaluating reward:risk and cutting your losses, but losing traders continue to outnumber profitable ones by a wide margin because they don't know when to cash in their chips and walk away. Frankly, no one can help you to take opportunistic profits or inevitable losses if you don't help yourself. Of course, all strategies experience drawdowns, and profitable ones are no exception, but a large cadre of traders are so shackled by greed and fear they routinely abandon great methodologies because the adverse price swings hurt too much.

There are a lot of reasons traders trade, but the only legitimate one is to make money. After all, that's why you got hooked on the financial markets in the first place. Let's do a quick reality check. Are you making money this year? If so, is it enough to pay the bills or at least earn bragging rights with your family and friends? How did things go in prior years? Are you any closer now to consistent profitability than you were two, three, or five years ago? Profitability is a question of nature versus nurture to some extent. In other words, some folks are natural born traders, while the rest of us need to spend lifetimes compensating for our genetic shortcomings. Fortunately, key trading attributes, such as risk-taking, can be learned by anyone with a genuine love of the markets and a keen interest in self-discipline.

It makes perfect sense for losing traders to study the habits, mindset, and strategies that winners take into their profession each day. This contemplation gives them a chance to mimic the winners and to internalize the discipline needed to improve long-term performance. Realistically, losing traders hate to think about "the D word" because it's not as sexy as becoming a market gunslinger, but it's the only realistic path to survival. That's ironic because the folks ignoring the most obvious reason for losing money are the same ones who spend thousands of dollars attending trading seminars. And, sadly, personal discipline is the one thing you can't learn sitting in an audience.

POSITIVE EXPECTANCY

Discipline and money management go a long way toward making you a profitable trader, but let's be realistic. However you trade, you need to

be confident in the positive expectancy, or trading edge, of your methodology, system, or plan. This poorly understood concept refers to how much profit you can reasonably expect to make versus each dollar risked on a trade. Gamblers live and die by this equation, which is better known in a casino or at a card table as the player's edge. The math behind the concept is very simple:

POSITIVE EXPECTANCY

$$\text{Expectancy} = (PW \times AW) - (PL \times AL)$$

PW: probability of a winning trade

AW: average gain

PL: probability of a losing trade

AL: average loss

In the real world, most of us don't understand our strategies well enough to determine whether or not they have positive expectancy. System traders rely upon back testing to divine these magic numbers, while discretionary traders need to compensate for their meeny-miney-mo decision making through extensive record keeping and thorough analysis of each outcome. Even so, it's still easy to fool ourselves into believing our approach has positive expectancy when, in truth, it doesn't. The sell side of the positive expectancy equation is far more important than the price and time you assume the risk of a trade. In fact, research suggests that a profitable system can be built using random entry. Yes, you heard that right. It's theoretically possible to turn a profit in the same way as a chimp hitting the bull's-eye throwing darts at a dartboard. Unfortunately, our hairy primate suffers from the same fatal flaw as the losing trader—he or she doesn't know when to take money off the table.

The mental aspect of positive expectancy is more difficult to manage than the pure numbers game. Many traders stop executing perfectly good strategies when they don't get the instant gratification they want from the financial markets. They get stuck in a vicious cycle in which they trade a strategy until it frustrates them to the point that they abandon it and go looking for another strategy. In the process, they never take the time to find out whether or not the methodology had positive expectancy in the first place, i.e., they didn't let it mature enough to watch its true potency bear fruit.

Which brings us back to the thorny subject of discipline. Of course it's boring to plan the trade and trade the plan, but it's the only reliable way to break the loser's cycle and get on the road to consistent profitability.

THE SURVIVALIST TRADING PLAN

Trading plans come in all shapes and sizes. A few talented individuals can jot down their entire plans on one side of a napkin and use those bullet points to build a successful career. More analytical types may write volume after volume, addressing every detail of their daily actions, mental processes, and filtering mechanics, and then follow up with a closetful of trading journals. A robust trading plan for the rest of us falls somewhere in between these extremes, where it's dangerous to think too little about the subject but counterproductive when we give it too much of our attention. Simply put, our plans must establish the rules of the road, pointing out what will be done and what will be avoided during the market day. They need to cover all aspects of profit and loss, including reward targeting, stop loss placement, and risk tolerance. We then internalize those rules, criteria, and strategies to avoid the traps and pitfalls of our modern electronic markets.

The survivalist trading plan takes the additional step of shifting focus toward the risk side of the profit and loss equation, at the expense of common technical analysis and popular market folklore. It examines all opportunities with a skeptical eye, mindful of diabolical forces and program algorithms that could enter the market at any time and overcome the natural flow of supply and demand. It works in harmony with those influences whenever possible, picking the pockets of weak-handed traders playing the same old systems, styles, and methods. Finally, it recognizes the overriding force of pattern failure in our modern market landscape and develops opportunistic strategies to take advantage of this counterintuitive reality.

Draw up your trading plan, follow it for a few weeks, and then start an introspective journal that lists every position and how it works out. Make small adjustments going forward, testing each modification, but don't be in a rush or assume you're wrong just because the plan doesn't reward you with instant gratification. Save your big changes for weekends and holidays, when you have more time to examine the potential impact away from the heat of battle. After a few weeks or months, compare the

plan to your daily journal notes, and see how your actions and omissions characterize your individual style. The trading game demands constant tinkering, and an honest journal will keep you focused squarely on your long-term goals. However, never use it as an excuse or a reason to make bad decisions.

The survivalist plan needs four key building blocks. Once you've established your plan, run each opportunity through this gauntlet of market dynamics before taking a position. The time you set aside for this filtering process will be well spent because it will uncover the best trades while pointing out hidden dangers before you actually put your money at risk.

- 1. Prediction.** Prediction comes in two flavors. You can predict that price will move up or down, or apply a bilateral strategy that takes advantage of whichever way the trend eventually breaks. Choosing a directional play requires one additional task. You need to place odds on the probability that price will move according to your prediction, within the specified holding period. This can be quite difficult because most of us don't understand how our trades really work in the first place.

Here's a useful hint in establishing trade odds. The probability of a prediction working as expected rises or falls depending on the frequency of cross-verification. This major concept from *The Master Swing Trader* takes the pattern and looks for convergence-divergence relationships through a variety of moving averages, Fibonacci retracements, trendlines, gaps, and technical indicators. The bottom line: the more charting elements that line up with your predicted uptrend or downtrend, the higher the odds it will actually happen.

- 2. Timing.** You can make or lose money only during the actual time you're in the market, so it's important to choose your battles wisely. Of course, you can look back at a chart and find all the great trades you missed, but real-life decisions need to be made at the "hard right edge," which is the part of the chart you can't see because it hasn't happened yet.

Define your holding period—i.e., how much time you want to spend in a position—before taking on risk. It's a critical decision because your trade needs to complete the anticipated price swing within this time frame. Clearly, the many levels of price-time coordination required in a good trading plan take a good deal

of experience. You might think, “Why even bother? I’ll just stay in the market until I get my move.” Unfortunately this approach doesn’t work because risk increases as a function of your time in the market. Conversely, the tradable pattern and your entry price cap reward potential, so that side of the equation doesn’t increase over time. This disconnect can put you into a very dangerous situation.

- 3. Volatility.** Each trading opportunity carries a specific volatility profile that needs to be examined before taking a position. This is important because more volatile markets move a greater distance over a shorter time period than less volatile markets. Simply put, this element will eventually translate into your profit or loss. The best trades generally align with volatility breakouts, i.e., movement from a low into a high volatility state. This aligns with the negative-positive feedback interface, which *The Master Swing Trader* covered in great detail. Now here’s a trader’s secret: getting into a position while volatility is low almost guarantees a decent reward:risk ratio.

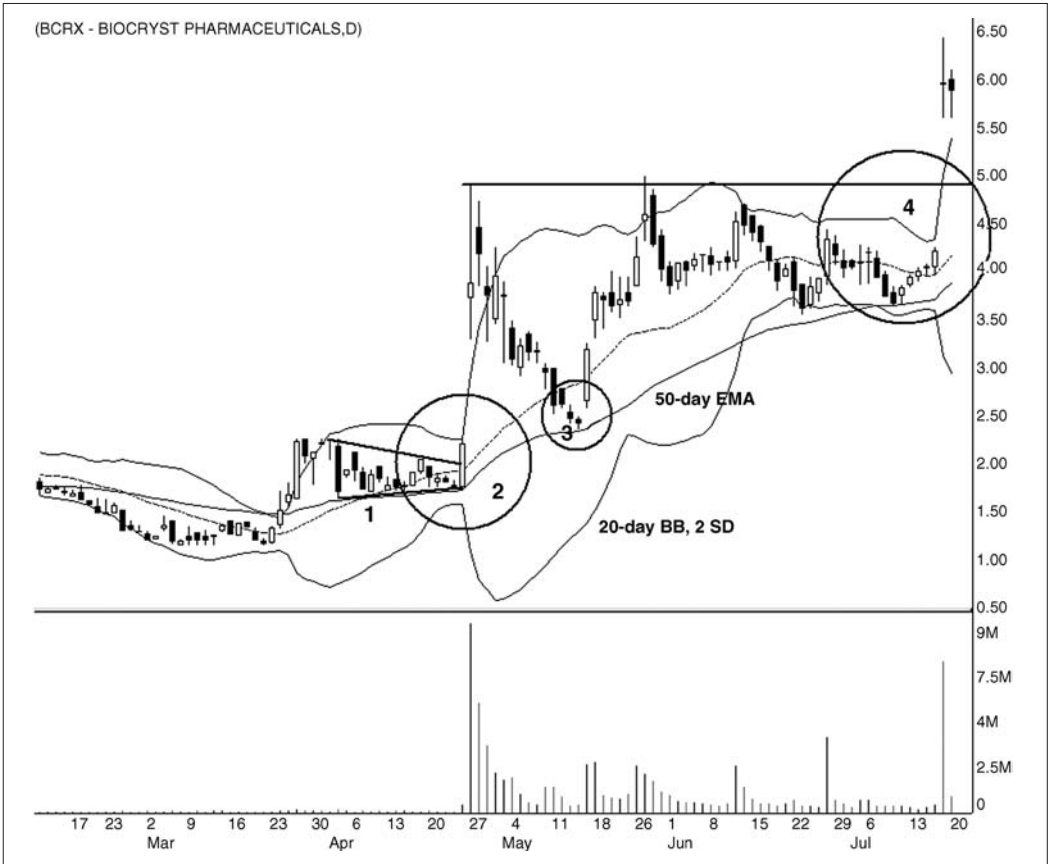
However, recognizing and trading cyclical shifts on the trend-range axis requires well-honed pattern reading skills. For example, a symmetrical triangle signals a breakout or breakdown through price contraction about two-thirds of the distance between the start of the pattern and the nexus point, where the converging trendlines will cross. However, that observation is often dependent on the number of alternating waves within the triangle prior to the narrow range signal. In most cases, triangles need to complete five swings before they’re ready to break out or break down. So, the pattern reader needs to combine two sets of observations into one well-organized opinion that yields a single good trade.

You can measure current volatility cycles on your trade prospects in just a few seconds using a three-pronged visual analysis:

- Price bars expand through periods of high volatility and contract through periods of low volatility.
- Bollinger Bands expand sharply during active trends and then contract when markets ease into trading ranges.
- Price/moving average relationships expose longer-term cycles, with reversion into averages setting the stage for the start of new expansion cycles.

FIGURE 5.1

BioCryst Pharmaceuticals awakens from a long slumber.



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Let's see how these tools interact on the BioCryst Pharmaceuticals chart to pinpoint cyclical shifts in volatility as well as excellent profit opportunities. In Figure 5.1, the stock wakes up from a long bear market and settles under \$2 in April. It moves sideways for a month in a symmetrical triangle pattern (1) while Bollinger Bands and price bars contract. It then gaps higher (2) on heavy volume, shifting from a low into a high volatility state, and stalls out at 5. The stock pulls back and hits the 50-day moving average (3), prints an NR7 (the narrowest range price bar of the last seven bars), and takes off in a vertical recovery that stops at

resistance, yielding the next leg of an ascending triangle pattern. Bollinger Bands then contract sharply, and the stock settles into a trading range until mid-July, when it tags the 50-day EMA for the second time. Price ticks higher for five sessions and goes vertical in a high volume breakout (4) that forces the Bollinger Bands to expand once again.

- 4. Risk.** I walked up to a brilliant trader a long time ago and asked him to reveal his secrets. With Zen-like clarity, he uttered two words in answer to my question: “control risk.” It took me years to understand how literal his comments really were. Amazing as it sounds, you can safely ignore the first three elements of your trading plan and still turn a profit, as long as you aggressively control risk on every position.

Let’s take this revelation one step further. In truth, you don’t need a pattern to trade, or even know which way price is headed in order to take money out of the markets. That’s right, you can be profitable just taking low-risk positions and managing them ruthlessly. The greatest challenge, of course, is to recognize the nature of risk in the first place. Most traders do a terrible job in this regard and resist taking the steps needed to overcome this career-ending myopia. Why does this happen? Well, for starters, most of us are running around like rats in the maze, too busy chasing the magic cheese to watch out for all the traps and dead ends.

Your job is just half done after you’ve taken these four building blocks and created a workable trading plan. To finish the process, you need to customize each element to fit your experience level, position in life, and personal liquidity. Here are 10 ways to accomplish this task:

- 1. Define a personal style.** This includes your execution rules, instrument choices, position size, and the filters that tell you when it’s time to stand aside.
- 2. Match the plan to the realities of your life.** Choose a suitable holding period because everything else is defined by it. Base your decision on experience and available capital. Then take into account lifestyle considerations, like family and free time.
- 3. Review your trading goals.** Is risk aversion or financial return more important to you? Do your profits need to pay the mortgage or just finance the next vacation? If you’re not sure what your goals are, trade small until you figure them out.

4. **Align position size with equity stake and risk tolerance.** Never overtrade a small account in hopes of building it up. Apply the limited stake to longer-term positions rather than flipping it repeatedly. Decide when and how to use margin.
5. **Define your entry and exit rules.** Decide what your opportunity needs to look like before taking the trade. List out exactly what must happen in the minutes or hours before you pull the trigger.
6. **Choose how many shares you want to trade for each position.** Take more shares when your ducks line up in a row, and reduce size when they don't. Limit shares to manage risk, and trade smaller when experimenting with new tactics.
7. **Will you use limit or market orders?** Will you use physical or mental stops? A lot depends on whether or not you're sitting in front of your trading screen all day. If lifestyle keeps you away from the markets, place physical stops on all positions.
8. **Create a quiet space to modify your trading plan going forward.** Fresh tactics require new risk considerations. Don't let your plan strangle new ideas, but add them slowly, and make sure they're a measurable improvement to the big picture.
9. **Decide where to focus your efforts at the start of each market day.** Your time is limited, and it's easy to get overwhelmed, so save your energy for the most urgent tasks.
10. **Choose information sources.** Will you listen to the news or the numbers? Will you trade through economic releases, or close out ahead of the news and step to the sidelines? Finally, decide if the boob tube stays on or off during market hours.

Now it's time to put your trading plan into action. Realistically, there are many ways to lose money in the financial markets, and, if you play this game long enough, you'll get to know most of them intimately. Fortunately, a survivalist plan empowers you to avoid many of the traps and pitfalls faced by other traders. Above all else, learn the five market scenarios that place you at the most risk:

1. **Bad markets.** A good pattern won't bail you out of a bad market, so move to the sidelines when conflict and indecision take hold of the tape. Your long-term survival depends on effective trade management. The bottom line: don't trade when you can't measure your risk, and stand aside when you can't find your edge.

2. **Bad timing.** It's easy to be right but still lose money. Financial instruments are forced to negotiate a minefield of conflicting trends, each dependent on different time frames. Your positions need to align with the majority of these cycles in order to capture the profits visualized in your trade analysis.
3. **Bad trades.** There are a lot of stinkers out there vying for your attention, so look for perfect convergence before risking capital on a questionable play, and then get out at the first sign of danger. It's easy to go brain dead and step into a weak-handed position that makes absolutely no sense, whether it moves in your favor or not. The bottom line: it's never too late to get out of a stupid trade.
4. **Bad stops.** Poor stops will shake you out of good positions. Stops do their best work when placed outside the market noise, while keeping risk to a minimum. Many traders believe professionals hit their stops because they have inside knowledge, but the truth is less mysterious. Most of us stick them in the same old places.
5. **Bad action.** Modern markets try to burn everyone before they launch definable trends. These shakeouts occur because most traders play popular strategies that have been deconstructed by market professionals. In a sense, the buy and sell signals found in TA books are turned against the naive folks using them.

YO-YOS

There are three types of traders in this world: winners, losers, and yo-yos. It doesn't take much effort to comprehend the virtues of winning or the liabilities of losing, but what exactly constitutes a yo-yo trader? Quite simply, these folks know how to make and lose a ton of money, sometimes all in the same day. Sadly, yo-yos make up such a large segment of the trading population that they may represent the silent majority of the financial markets.

This common affliction is simple enough to understand. Many traders develop enough skills to put on profitable positions with relative ease, but they also play all the stinkers, paying the price with substantial losses. In this bipolar purgatory, there's enough positive reinforcement to keep them in the game for years but not enough profit to make a real dent in their bottom lines.

Yo-yo traders comprise two very different profiles. The first type grinds through mediocre results on a daily basis, hoping that lightning

will eventually strike. The second type shows profitable results over long periods, only to crash and burn in an orgy of bad trades over equally long periods. All traders display both types of yo-yo performance from time to time during the course of their careers. The trick is to recognize the onset of yo-yo performance as early as possible and to engage in prophylactic practices that will reduce the inevitable damage.

Two major flaws lead to yo-yo trading performance. First, the afflicted individuals lack effective risk control techniques. This causes them to act inappropriately, or not at all, when positions move against them. Unfortunately, operant conditioning kicks in at the worst possible time because they've gotten bailed out often enough to believe the market will come back in their favor if they just wait it out. Of course, the math fails to add up, and bad karma takes over with rising losses and dwindling profits.

The second flaw reveals a far steeper challenge to long-term survival. Their equity growth actually tracks the market and looks like an index chart. In other words, these yo-yo traders make money when the broad market is rising and then lose it when it rolls over and starts to sell off. This is a tough proposition because the secret to long-term success is holding onto your winnings through all kinds of markets. This major defect exposes a bull market mentality that reaps destruction during pullbacks, corrections, and every downdraft in a typical week. Unfortunately, it's also how most traders play the markets because it follows an unconscious mindset that confers legitimacy solely to uptrends while assuming that all other environments are aberrations or freaks of nature. This mental mistake reveals the primary reason so much money was lost after the March 2000 and July 2007 tops.

Even seasoned traders are vulnerable to this flawed mentality. The narcotic of rising markets causes them to limit their efforts to the momentum chase rather than building strategies based on pattern cycles and an overriding respect for risk. Then, when the market fails to offer perfect conditions for their narrow tactics, they forget the only sensible path is to stand aside and wait. Sadly, most traders lack discipline in adverse markets and try to force the tape to their will, often with very bad results. Or their restless minds fill in the missing pieces and see patterns or opportunities that don't exist. This combination of wishful thinking and aggressive overtrading triggers sobering losses until the trader finally wakes up to reality or washes out of the market.

The yo-yo mentality may end careers in other ways as well. The daily demands of this game are so intense that borderline participants just get lazy and develop a self-destructive style. Fatigue then sets in while the mind struggles to organize shifting markets, forcing many shades of gray to resolve into black and white. This unconscious pattern fitting exercise causes positions to become all or nothing affairs, with wish fulfillment distorting incoming signals.

Traders afflicted by yo-yo disease need to face the sobering facts. They came into this game wanting to take money out of the markets, but the endless cycle of winning and losing means they're stuck on a treadmill going nowhere. And, without a major change in attitude and technique, these folks are doomed to failure. Realistically, the transformation from a yo-yo into a winning trader is far more difficult than the simple transition from a loser into an occasional winner. In truth, it's a major reprogramming exercise because these folks have received just enough positive reinforcement from bad decision making that their unconscious minds believe they're firmly planted on the road to success. The good news is that these individuals can undergo a true awakening but not before they realize the hopelessness of their situation. In many cases, the conversion needs to come from an external source, like a spouse fed up with market war stories that never pay the bills.

Here are four things you can do right now, on your own, to get off the yo-yo treadmill:

- 1. Ration trades.** Most yo-yos lose the bulk of their money trying to get even after a bad day or getting too aggressive after a good day. Set a flat figure for the number of trades you'll execute in a single session, and then stick with it.
- 2. Cut size.** Greed and fear play a huge part in yo-yo behavior. Smaller trade size will help you to stand your ground in good trades and feel less miserable when stop losses get hit.
- 3. Play a shorter watch list.** Prepare a list of five or ten stocks to trade in the next week or month, and don't take positions in anything else. Don't trade at all if those stocks don't set up good opportunities.
- 4. Get it and get out.** Set a dollar threshold for daily gains or losses, with the gain size at least twice the loss size. Get out of the market for the rest of the day as soon as either threshold gets hit.

LONG-TERM PROFITABILITY

Markets don't go up all the time, which is a big problem for traders with a long-side bias. These folks get so used to buying breakouts that they forget how tough it is to hold onto profits when the major indices start to roll over. In addition, most of us find it hard to stop taking the plays that worked for a long time after they stop working. I guess it's human nature to repeat the behaviors that bring us rewards, even after the rewards have dried up. Just ask Pavlov's dog about that mystery meal he was drooling over when the dinner bell rang.

The first requirement for holding onto profits through corrections is to change the trading strategy as soon as you realize it's no longer working. Consider that you'll miss only one or two good profits if your paranoia turns out to be wrong. In other words, if the market does a head fake and suddenly recovers, you'll miss out on the first upswing and then resume your preferred breakout strategy. More likely, your original caution pays off, as expected, and the market grinds lower for a few weeks or months. This is the period in which your adaptive trading style pays great dividends. You'll not only preserve the nest egg you made on the upswing, but you can now add to your profits through targeted plays that work in corrective environments.

Realistically, turning a trading strategy on a dime takes considerable discipline. No doubt you'll get jumpy whenever there's an uptick or a piece of good news that lifts the markets, even for a few minutes or hours. In fact, the fear of missing out is a chronic disease contracted by nearly all market players. So, if you absolutely can't avoid the temptation, go ahead and trade these countertrend bounces with small shares and a tight stop loss. In this way you can take advantage of the uptick but still respect the likelihood that you're walking into a trap.

The five Ss will save long-biased traders a lot of grief during pullbacks. They're so versatile you can apply them to both short-term downswings and long-term downturns. At a minimum, they'll keep your trading account intact and ready to go on the next rally:

- 1. Selection.** Lower your beta during pullbacks, and look for less volatile stocks to trade. This means laying off small caps and chat room plays while you check out slow movers that grind through average daily ranges of less than two points. It's also a good time to look over defensive plays in utilities and consumer durables. In addition, watch for rotation from hot sectors into

cooler ones as investors take profits and look for other places to park their capital.

2. **Scalping.** Shorten your holding period and stop looking for multiple price waves in your favor. Make it easy on yourself. Just assume every position you're holding is at risk, and the correction won't end until all your stops get hit. The best way to play during these volatile periods is to take profits early and buy back later at lower levels. It's also a good time to sell immediately after you get your buying spike. For example, you jump into a triangle pattern just before it breaks out. Sell into the top of the first swing after the breakout rather than holding on in anticipation of trend day.
3. **Size.** Lower your size during a downturn. Traders love big plays when markets grind through strong uptrends, but risk increases dramatically during corrective phases. Smaller size lets you survive the stomach-churning action typical in an environment where weak hands get shaken out of good positions. It also lets you test the waters with limited risk as the market nears an intermediate low. Here's how it works. Pick up a few shares and play the bounce, in hopes it'll turn into a larger scale recovery. If you're wrong, take the small loss and look for a better entry. Rinse and repeat as needed because sooner or later you'll get it right and make back a nice chunk of the lost capital.
4. **Sidelines.** Bad decisions in dangerous markets will undermine months of hard-earned profits. Consider that each dollar you save during a correction is a dollar you've earned for your trading account. Invariably, corrections generate selloffs interspersed with long periods of boredom while the market tries to recover. It's best to stand aside during these periods because opportunity-cost is unfavorable. Also, keep in mind that V-bottoms are a dangerous fantasy that serious traders can't afford to indulge in. In other words, when the market goes straight down, don't expect it to recover without a long period of back and fill.
5. **Shorting.** It may come as a surprise that short selling is the last strategy needed to survive a correction. In the real world, most long-biased traders can't change hats during a pullback because their buy side mindset trips up the mentality needed to sell short profitably. As a result, they get overly nervous when they sell the market and wind up panicking on the first squeeze. In addition, short sales are difficult to time when selloffs occur in bull markets because there's a tremendous amount of buying power floating

around. It's a different animal during bear markets, when short sale profits can be as smooth as silk, especially in the latter stages, like in 2002 and early 2009.

THE REAL BOTTOM LINE

Tactical, emotional, and perceptual issues all come into play when we try to pinpoint our bottom lines. This is especially true when we've set up multiple accounts to play the financial markets. Each cash horde may serve a different purpose, especially when retirement funds make up a good part of our assets. And, to complicate matters, we've been trained over the years to regard profitability in those funds from a different angle than the speculative capital placed into trading accounts. This is where the big lie usually begins. It goes something like this. You make a little money in your 30K trading account but lose a big chunk of your IRA or Keogh because of bad positions or a bad market. Despite those losses, you see yourself as a profitable trader because of the misconception that retirement funds will pay you back at some mysterious date in the future.

Of course there's only one way to address this delusional mind cramp. You need to combine all your assets and positions onto a single data sheet and compute your total return from that single point of reference. You'll find this is tremendously difficult to do if you've been ignoring your long-term positions in an unconscious effort to fool yourself into thinking you're a market gunslinger. This is especially true after you pass your fifty-fifth birthday. Most retirement funds can be tapped without penalty when you reach age 59½, so that pool of money no longer represents a distant nest egg that doesn't need to perform on a daily or monthly basis. Rather, it might represent the lifeblood of your golden years. I can't overstate the importance of combining all accounts when looking at profits on a weekly, monthly, and yearly basis. Traders are highly emotional animals, subject to all kinds of self-sabotage, and the profit/loss bottom line is the only truth serum for the business we've chosen for ourselves. Everything else is just entertainment and a huge time sink.

On the flip side, avoid overkill when it comes to your combined profitability analysis. It's just crazy to insist that every day or week draw a perfect profit, but looking at monthly and yearly numbers makes total sense. This longer-range filtering lets us suffer through a string of bad days but also gives us time to crawl out of a minefield of deep holes.

As we all know, a few of them in recent years have been especially dark and damp. How detailed does your profit/loss analysis need to be? Personally, I've gone from overkill to the KISS method in the last decade. Initially I was keeping pages of detailed statistics that covered every aspect of my trading results. But these days I just track the equity curve in each account while noting all interest, fees, and dividends that might skew the numbers.

Playing with percentages is another way that traders lie about profits. Simply stated, percentages don't matter in small accounts, but they're extremely important in big accounts and retirement funds. In other words, it means little if you double your money on a \$10,000 account, but just try that magic act when flipping a half million bucks or more. And don't average percentage gains across multiple accounts. This is a delusional practice where you take all the percentages and divide by the total number of accounts. Instead, you need to add the assets in all accounts and divide by the total profit or loss. You might not like what you see, but at least it's an honest number. Newer traders really shouldn't focus on percentage gains or losses at all. Dollars and cents tell the tale more reliably when it comes to learning your way around the financial markets. Your only job in your first years of trading is to increase the bottom line over time, with few detours. It doesn't even matter if the gains increase by just a few bucks each month as long as the equity curve is moving in the right direction.

Traders have very short memories. They'll blow out their accounts in a barrage of bad positions but then assume they've turned profitable as soon as they have a good week or month. This myopia is very popular when markets turn higher after long corrections. Losing traders assume that red ink incurred during those periods is an aberration that doesn't reflect "real" performance, so they purge the bad times from their conscious minds and data sheets. Of course, all traders go through regular drawdown cycles, and it makes no sense to restrict data analysis to the last period of relative good or bad performance, or markets.

Long-term profitability begins with the realization that there are no big or small plays at work in the financial markets. In other words, we need to manage each position in a consistent manner and take our trades according to a predevised plan. After all, this is an odds game in which success comes from small edges exercised over long periods of time. That's why you can't cut corners when examining your profitability. Accept the fact this is a huge undertaking in which most applicants are destined to fail over time. In that sobering reality, you'll understand why a reliable feedback system that accurately measures progress over time is your most potent weapon in the battle for the bottom line.

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6

C H A P T E R

SURVIVALIST TRADING STRATEGIES

It's natural to believe in the market's upward bias, even though it's a path to chronic underperformance. In the real world, all financial instruments move in both directions over time, and you won't survive as a one-trick pony, giving back your gains on every downturn, whipsaw, or head fake. Clearly, most of us are conditioned to chase upside momentum and to let our positions run after big rallies. This herd mentality undermines our ability to hold onto gains when more challenging conditions take control of the ticker tape. In response, we need to apply survivalist strategies to ensure that hard-earned profits stay in our pockets, where they belong.

The first challenge in a survivalist strategy is a psychological one. Traders find it almost impossible to stop taking the positions that yielded profits for two, three, or four months, even when they stop working in a mutating market environment. This is Pavlov's dog syndrome, where we salivate right on schedule every time the dinner bell rings. It comes down to this simple truth: our small trading edges are moving targets that

disappear when the crowd piles into a popular strategy. It's the primary reason bull traps are sprung with great frequency after long rallies, while squeezes crush short sellers in the middle of persistent selloffs.

Standing aside is a major component in every survivalist trading strategy. In other words, reduce trade frequency when the market turns, and then cut it to the bone if your few positions don't respond with immediate profits. Alternatively, you're on the right track if fewer trades equal more profits. In addition, the time you spend as an observer rather than a participant provides a more objective view of price action and market direction. Once you've changed gears in response to waning inefficiency, look for trades that will respond to the next wave of trend or range activity. A survivalist approach really pays off when the market turns because you can take all the bucks saved by sitting on your hands and put them back to work. For example, you're chasing breakouts in a strong market when the major indices roll over. Your daily performance starts to deteriorate as sellers come out of the woodwork and bang down prices. Recognizing the market shift, you head back to the sidelines and wait for the indices to drop into support at the 20-day SMA or 50-day EMA. As the falling market hits these levels, your nightly scans explode with pages of bull setups in which strong stocks have pulled back to support and triggered dip trip buy signals.

Keep an eye out for short- and long-term rotations. Make a list of 35 to 40 sector indices or their related exchange-traded funds and put them onto a single watch list. Sorting these instruments by daily and weekly percentage gain/loss lets you track rotational events in real time. Note which market groups tend to move in tandem, like retail and home-building, and which usually track against the major indices, like precious metals. Market players move money out of hot sectors all the time, looking for better places to park their capital. You've found a considerable trading edge if you can decipher where all this cash is headed faster than your competition.

FIVE COMMON ROTATIONS

1. Beaten down sectors with the worst looking charts attract capital when strong markets roll over.
2. Hot tech money heads into defensive groups, like health care, foods, and drugs, when rallies overheat.

3. Traders abandon commodity stocks and toss the cash into blue chips when economic growth slows or stalls.
4. Cyclical attract buyers in the early stage of economic growth and lose them when the expansion phase gets under way.
5. A strong dollar favors small cap rallies, while a weak dollar favors commodity rallies.

SWING ANALYSIS

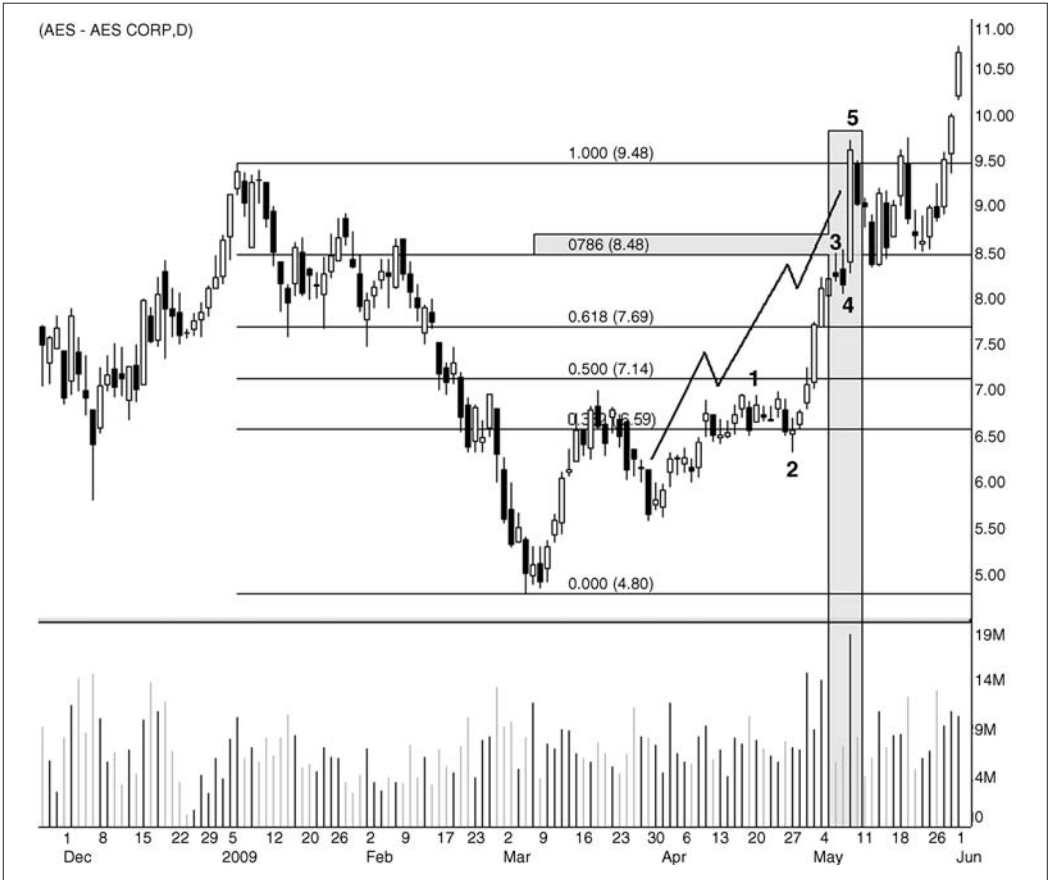
It's tough to make money if you don't know where the swing began, how far it might carry, and when it's finally over and giving way to a new swing in the opposite direction. Every aspect of your trade, including holding period and reward:risk profile, is dependent on the size of the swing. Swings occur in all time frames, so it's equally important you know which one you're actually trading. Measuring the current swing starts with a good set of eyeballs, a.k.a. the most overlooked technical tools in your trading arsenal.

Swings tend toward proportionality. For example, an 18- to 20-day price swing in one direction will often be followed by an 18- to 20-day price swing in the opposite direction. To complicate matters, these proportions can be subdivided into fractions, with one side swinging 5 against 10, 8 against 16, and so forth. Past swings will set up fractal mathematics with current swings. For example, when you see a series of 15-bar swings in the last year, odds are high the instrument you're examining will swing in 15-bar intervals this year. You can predict swing size by comparing the angle of attack, i.e., slope of the trend, against the slopes of prior swings, in either direction. Contrary to common sense, more vertical swings persist for shorter time periods than more gradual swings. This goes back to basic physics, in which a star that burns the brightest tends to burn out sooner than a star emitting a cool red light. This price-time continuum becomes extremely important in profit targeting and exit timing, aligning closely with the old adage to "buy in mild times and sell in wild times."

The vertical price bar in all time frames and instruments is a major signal for traders to stop what they're doing and pay close attention because the trend is accelerating, often toward a goal at which the swing, in that time frame, will end abruptly and give way to a counterswing. This dynamic often occurs in the last 20% to 25% of a retracement back to an

FIGURE 6.1

The vertical price bar shows up at key intersections of price and time, often signaling the end of a swing in either direction. AES Corporation sells off from 9.48 to 4.80 and bounces in March. The stock ticks higher in a series of rally waves, finally reaching the 78.6% retracement of the last downswing. The rally lurches forward in a wide range bar that completes the 100% round trip and prints a first rise pattern. Note how the big bar also yields the final wave of an Elliott five-wave rally set within a larger third-wave rally.



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old high or low. In Fibonacci lore, the 62.8% and 78.6% retracements mark the last lines in the sand for price to reverse and start a counterswing. The mounting of the last Fib barrier, at 78.6%, often triggers a surging market that completes the 100% retracement and hits a larger scale support or resistance level. This follows the mechanics of the first rise/first failure pattern discussed in *The Master Swing Trader*.

Above all else, price swings denote the major highs and lows that stand out on the charting landscape. Markets seek out these highs and lows, as well as any barriers (like gaps) that block movement into these magnetic levels. These inflection points then become price targets for our trades in both directions. When we evaluate progress within a swing and properly analyze the angle of attack, we can estimate, sometimes with amazing accuracy, how long it will take for price to get to a major termination point. This magic number then determines the holding period for all positions that are intended to take advantage of that particular swing. The devil is in the details because the markets move through multiple swings in different time dimensions simultaneously. This goes back to the concept of trend relativity, which affects every aspect of our trading performance. In a nutshell, trends move independently in all time frames until they come into the territory of larger-scale swings, which then take priority. You've committed a logistical mistake, which I've dubbed the trend relativity error, when you find a swing in one time frame but trade it in another time frame.

Debris within the charting landscape increases or reduces the odds that price will complete a 100% swing back to the last high or low. Gaps, trendlines, and moving averages all stand in the way of progress toward those magnetic price levels. These barriers need to be reviewed and measured as part of our trade preparation because each one has the power to force a reversal well below an old high or above an old low. The distance between the entry and termination point of the current swing denotes the initial profit target. The distance between the entry and inception point of the current swing denotes the initial risk or failure target. Your analysis then reduces reward and risk, taking into account any debris above and below the entry price that is likely to trigger reversals. Once completed, you're looking at a quick snapshot of what you might gain or lose on that trade.

You can modify the reward side of the equation even further by increasing your holding period to accommodate small-scale counterswings within the bigger swing, i.e., consolidations and corrective waves. You can modify the risk side of the equation even further by shortening up your holding period and placing stops behind small-scale counterswings that have already printed within the bigger swing. Finally, you have the option of reducing risk even more by using absolute or percentage based stops that will take you out of the trade at prespecified loss levels.

Simply stated, the most profitable positions arise when there are few barriers between your entry and the last swing high/low and many barriers between your entry and the inception point of the current swing.

This marks the low-hanging fruit that shows up from time to time in the evolution of pattern cycles through stocks, futures, currencies, and the broad indices. It's surprisingly easy to train your eyeballs to find these favorable patterns when flipping through the charts, doing your nightly analysis. In fact, I find it amazing how few folks pay close enough attention to this reliable profit-making machine.

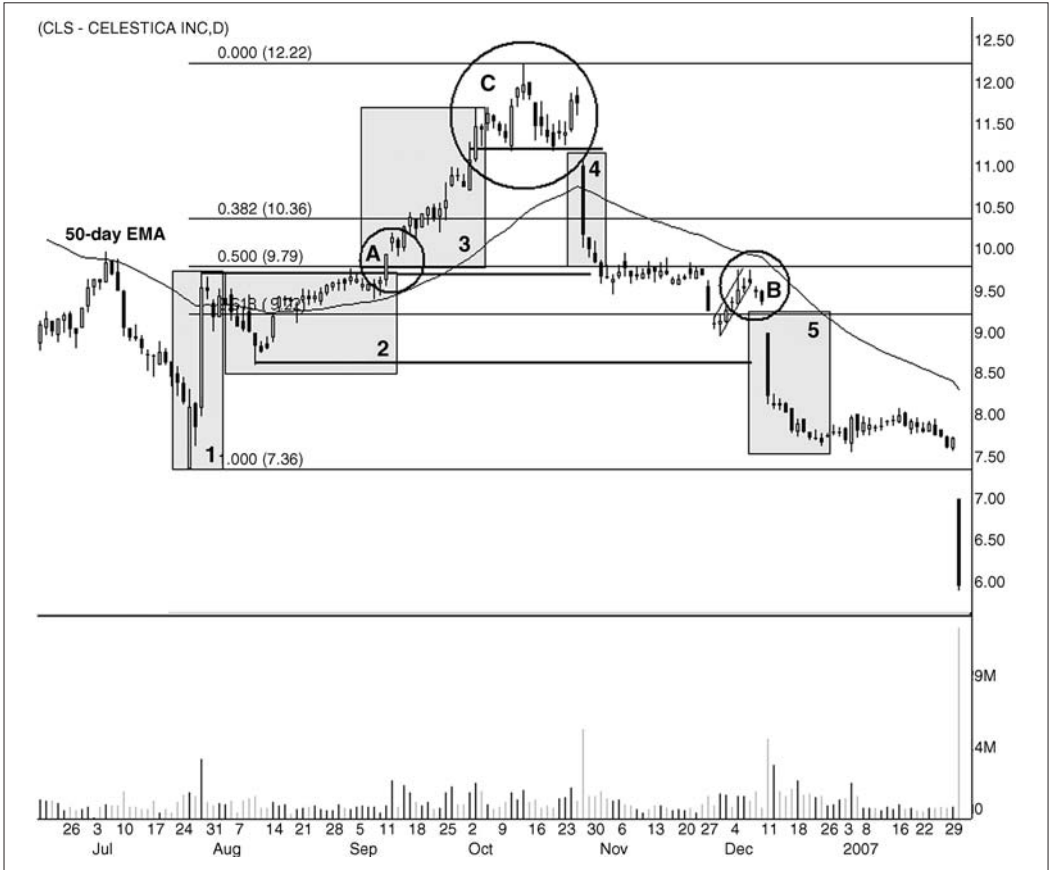
In Figure 6.2, Celestica rallies from 7.36 to 12.22 over a three-month period. The uptrend yields two sharp price waves (1,3), with a consolidation pattern (2) in between. The continuation gap (A) at 10 marks the halfway point of the larger-scale swing as well as a breakout from the six-week trading range. Note how this gap also prints a breakaway gap in a smaller time frame. The stock tops out in October, printing a small head and shoulders reversal pattern (C). It breaks down in a high volume gap and swings lower (4), retracing the entire breakout. Notably, the selloff also breaks the 50-day moving average, which now stands as resistance on any recovery attempt. The downtrend pauses right on top of the summer consolidation pattern (2) for over a month. Price finally breaks down, ticks higher in a pullback to resistance (B), and plunges in a second selloff (5) that retraces the first rally wave.

The convergence of the consolidation pattern (2) and continuation gap (A) marks the only barriers that are limiting reward potential during the initial selloff. The trader uses that price level as the profit target, with the failure target lying just above the neckline of the broken head and shoulders pattern. What happens if the trader is late to the party and the initial selloff bar is well under way? No problem, because the 50-day EMA breakdown sets up a new barrier on any recovery effort. In turn, this supports a new failure target just above the moving average.

In early December, the recovery attempt has run its course, and the stock breaks support around 9.50. This triggers an initial sell signal that can be entered on the downside momentum thrust. Better yet, wait for the pullback to resistance (B). The trader can then enter at the ideal price, where the small bars fill the gap at 9.70, or the ideal time, when price rolls over and breaks the six-day bear flag pattern. The failure target for the new short sale lies just above the gap or flag. The profit target is sitting at the low of the consolidation pattern (2), but selling pressure carries quickly through that support level. When that happens, there are no barriers until falling price reaches the inception point of the upswing at 7.36, so that level becomes the new profit target. The stock continues lower for the next two weeks, until downside momentum finally washes out and points to a time-based exit.

FIGURE 6.2

Celestica round-trip.



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The utopian “perfect” trade combines your well-defined edge with accurate swing analysis, utilizing a holding period that matches the specific opportunity. The edge, in this case, refers to your skill in finding decent patterns based on your personal experience, effective market scanning, and the concepts in this book. Accurate swing analysis refers to the profit and failure targets, modified by chart debris inhibiting favorable price movement.

Ask yourself the following two questions when pulling up a pattern that looks like a good trade:

- How far can it go before hitting the next obvious barrier?
- How long will it take to get from point A to point B?

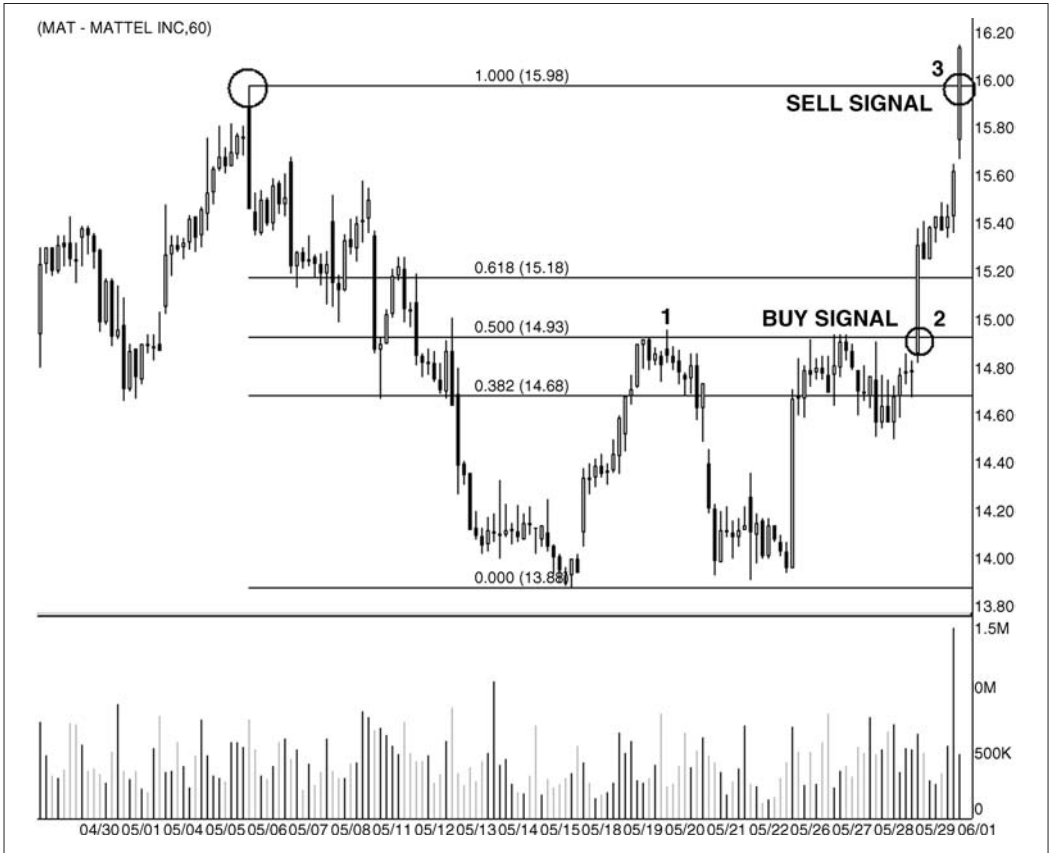
Your honest answers are more important than the pattern itself, which might show an attractive cup and handle, perfect rectangle, or a well-honed trendline. Simply stated, it doesn't matter if a financial instrument breaks out or breaks down when it has nowhere to go. This is a bigger problem than you might think, because traders routinely engage in an unconscious process of formfitting in which they focus narrow attention on the price pattern while ignoring the considerable obstacles that make actual trade risk unpalatable. This goes back to our love of the hunt. We get so excited uncovering a textbook pattern that we forget it means absolutely nothing unless the reward to risk profile is favorable and the swing size fits into our trading plan. Of course, price can overcome all the barriers between the entry price and the swing termination point, but most of our plans can't cope with the drawdown and extended holding period.

Context is everything in the financial markets. In other words, the significance of what's happening today is directly related to what happened in the past. That's why it is vitally important to evaluate the context of the current swing if you want to make good trades. No, it isn't an easy task because every financial instrument oscillates through multiple swings in multiple time frames simultaneously. Realistically, though, the size and structure of the last major counterswing usually provides the bulk of information needed for any trades that pass through those levels.

It's wrong to think of price swings as sawtooth patterns, with alternating V-shaped oscillation. Rather, a notable swing usually gives way to a trading range, often three to four times the length of the swing, which then yields to a trend in the same or opposite direction. This consolidation pattern adds actionable levels in the same way as any larger-scale topping or bottoming pattern. Fibonacci retracements come into play here because the current swing can be measured as a retracement percentage of the prior swing. A trading range often fills up the first 38% of the journey back toward an old high or low, limiting the best profit potential to the second half of the new swing. Trading ranges taking up less retracement space, say 20% to 25% in a typical scenario, offer more advantageous position taking than broader congestion patterns. You can see how this worked with the "compact" Celestica head and shoulders pattern, which took up just a minor portion of the evolving downswing.

FIGURE 6.3

Context is everything in the financial markets. Mattel sells off over two points and bounces at 13.88. It carves out a wide double bottom pattern that takes up 50% of the prior downswing (1). The stock finally breaks out (2) above the “Big W,” or center point of the double bottom, and triggers a buy signal. However, there’s now just a single point of profit between the trade entry and top of the prior swing (3), which will trigger a renewed sell signal.



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CONVERGENCE-DIVERGENCE

Charles Dow outlined the most famous convergence-divergence (C-D) analysis in market history when he wrote a series of articles that gave birth to the Dow Theory over 100 years ago. In a nutshell, he postulated that trends in both directions lacked persistence unless they were confirmed

through coordinated price movement between the industrial and railroad averages. In other words, the two big indices of his era needed to converge in order to “prove” that a bull or bear trend was valid. In addition, Dow insisted that volume had to support the trend, with participation increasing during movement in the trend direction and decreasing during movement counter to the trend. His logic assumed that rising volume in an uptrend pointed to convergence, while falling volume in an uptrend pointed to divergence, or the polar opposite of convergence.

There are literally thousands of C-D relationships in our modern markets. Therein lies the Gordian knot for the survivalist trader. If you don’t know which two data points to compare or which trend to compare them with, whatever information you glean from the analysis might turn out to be worthless. Even worse, your scrutiny could lead to inaccurate conclusions that yield misinformed trading or investment decisions. Ironically, this particular error cost market players as much money after the 2008 crash as the actual crash itself.

Technical analysis and tape reading rely on effective C-D interpretation. Not surprisingly, the subject matter overwhelms many traders because, literally, every two data inputs in the markets yield an underlying C-D relationship. To overcome these infinite variations, we need to keep things simple and find the narrow relationships that predict price movement, direction, and timing. Positioning of the major indices or their derivative instruments is the obvious place to start our C-D examination. Our primary analysis, day to day, simply compares the progress of our watch lists and active trades with the S&P 500 and Nasdaq-100 indices or index futures. We looked at this aspect in the second chapter, highlighting the impact of program algorithms on the C-D equation. In fact, you’ll find that C-D analysis is an overriding theme throughout this book and in *The Master Swing Trader*. If you take a second look at the cross-verification process outlined in the first book, you’ll discover it’s simply a set of convergence-divergence relationships. And so it goes through nearly every aspect of market analysis. That’s why attempting to trade profitability without becoming a lifetime student of cross-market influences is an exercise in futility.

C-D relationships are defined as bullish or bearish. This sets up four possible outcomes: bullish convergence, bullish divergence, bearish convergence, and bearish divergence. It’s perfectly normal to recognize a convergence or divergence relationship but not understand whether it will have a positive or negative impact on market movement, direction, and timing. To complicate matters even further, most C-D relationships have little or no impact on those three elements. Fortunately, common sense

and a little intuition go a long way in correct C-D interpretation. In other words, if the relationship “feels” bullish, it probably is, and if your tummy hurts because C-D is going haywire, it’s usually a good time to step back to the sidelines and reevaluate.

Ironically, the best way to check the accuracy of your C-D observations is through yet another C-D relationship. Take the bias you’ve established through your analysis, and compare it with broad market action. Does the ticker tape support or refute that bullish or bearish point of view? For example, you note a bearish divergence, but the tape remains in strong rally mode despite your misgivings. This signals a divergence between your established bias and the reality you’re staring at. It also means you’re probably wrong. You might not realize it, but this process of comparing predisposition versus price action is codified in the classic market wisdom to “trade what you see and not what you believe.”

Convergence-divergence analysis requires on-the-fly decision making. Say you’re holding three long positions overnight: a tech stock, a retail stock, and a bank stock. You wake up the next morning with the Nasdaq-100 glowing green while the S&P 500 is down a half percentage point. You check the news and discover that Google just raised estimates while Bank of America disclosed significant trading losses in the current quarter. Adding to the mix, monthly same store sales for the retailer you’re holding come in right on expectations. This diverse data flow has generated a myriad of C-D relationships that will mean the difference between a profitable morning and a total disaster. Start your triage by examining the most dangerous situation first—the bank stock getting hit by bearish sector news. Check the premarket quote to see how it’s trading *vis-à-vis* the prior close. Then compare the percentage loss, if any, to price action on Bank of America. At a minimum, your position should be lower by a smaller percentage than the issue hit directly by the news. Not surprisingly, it’s a major bearish divergence if it’s the other way around. Next, check if your stock is trading at, above, or below the next obvious support level. It’s a bullish divergence if it hasn’t broken support despite the news. Finally, compare price action in the opening minutes of the regular session to the bank index performance to see if it sells off a smaller or greater percentage. If bullish divergences add up, discount the news by holding on or reducing position size as opposed to selling outright. If bearish convergences line up or your analysis shows conflicting information, sell the bank stock and move on.

The tech stock is easier to manage because the positive Nasdaq-100 converges with your long-side risk. The addition of good news from Google adds another layer of convergence that supports the position

and raises the attractiveness of adding sector exposure. C-D analysis of the retail stock is more challenging than it might appear at first glance. On the surface, there's no obvious C-D relationship because the news matches expectations. But the perfect match actually generates all sorts of C-D data, starting with the market's reaction to the nonnews event. In other words, does the stock trade higher or lower, and how does that price action compare to broader sector activity?

Of course, it's extremely frustrating to watch a long position sell off after meeting high expectations. This is especially true during earnings season, which presents traders and investors with the most steroidal C-D events of the entire year. It also points out the tremendous value of decision making based strictly on C-D relationships and the underlying technicals, rather than relying on fundamentals, external opinion, or outdated portfolio theories.

Finally, the crazy quilt of C-D relationships addresses a question that's been posed repeatedly to me in the last decade: how can I learn to read the ticker tape? In truth, effective tape reading is nothing more than watching set after set of C-D relationships pass before your eyes and then translating those observations into accurate predictions of movement, direction, and timing. It's a deceptively simple practice that can take decades to master. And so it goes with convergence-divergence because there's no way to shorten the trader's path when it comes to divining the crosscurrents of economics, price action, and psychology that translate into the diabolical mind of the market.

DEFENSIVE SHORT SELLING

It isn't easy for most traders to make money by selling first and buying last. In fact, we have an uncanny ability to watch prices plummet for hours and then sell short at exactly the wrong time. Sadly, this is one of the great truths of playing that side of the trading game. Ironically, even a bear market can make life tough for short sellers because the diabolical tape will always find a way to punish the majority. Fortunately, the survivalist mindset provides a defensive workflow that avoids common pitfalls of this classic strategy, like chasing into a morning bear trap.

In most sessions, the markets show tremendous overlap in daily price ranges. In other words, pick out today's high and low for a particular instrument, and tomorrow's market will probably trade through

a good portion of that daily range. This is a big problem for short sellers because it undermines logical stop placement and makes low-risk entry prices harder to find. In truth, price goes nowhere most of the time, even in a bear market, with real declines occurring quickly and in sudden bursts of negative energy. This narrow window of opportunity means that sellers need to wait for a seller's market and/or risk getting burned because their timing isn't absolutely perfect. Even then, short selling makes a terrible group sport because many stocks attract overcrowding, which can trigger endless squeezes until weak-handed players get shaken out. And, just to rub salt into the wound, the most obvious selling spots routinely trigger the most violent squeezes. Taken together, these adverse dynamics warn us to travel the less trampled path if we're serious about selling the market.

Short sales require three primary attributes in order to book consistent profits: the right strategy, perfect timing, and extreme patience. If you can't meet all of these requirements, it's best to forgo the activity and limit your trading to the long side. Indeed, short covering rallies focus most of their bloodletting on weak-handed players who haven't perfected these interconnected components. The majority of profitable short sales will follow one of these four entry strategies:

- 1. Failed breakouts (2B reversals).** The 2B reversal sets up when a financial instrument at a new high fails a breakout by dropping under the last swing high. This failure usually takes place within one to three bars after the breakout, but it can occur much later. The actual sell signal triggers when price trades through the low of the first recovery bounce. These short trades can occur in all time frames but are especially effective on the daily chart, when price breaks out on high volume after much effort and then traps buyers in a wide-range selloff or gap down bar. You'll find a detailed example of the 2B reversal trade in Chapter 7 of *The Master Swing Trader*.
- 2. Pullbacks.** Pullback shorts rely on weak rallies into resistance after the financial instrument incurs obvious technical damage. This pattern can appear high in an uptrend if there's a notable gap that breaks support, but it occurs more often within the context of a well-established downtrend. In both cases, the sell signal triggers when price spikes into an obvious resistance level and rolls over, or above an obvious resistance level and then sells off, like the Canadian Solar breakdown discussed later in this chapter.

3. **Narrow range.** Selling short within narrow range patterns is less risky than chasing the market in either direction. This defensive strategy looks for tight congestion at a key support level after an instrument sells off in a developing downtrend. Enter the sell order within the two- or three-day range, placing a buy cover stop just above the short-term high in case price turns tail and heads into a larger-scale recovery.
4. **Momentum entry.** Shorting downside momentum is a highly risky strategy that can produce outstanding profits. The trick is to find an active selloff, like the bottom dropping out of the financial sector in 2008. Once you locate it, enter the weakening instrument and ride the downside while protecting your position with a percentage based stop loss. Exit discipline is the key here, because these volatile markets are subject to violent short squeezes.

A simple analog filter will improve your short sale stock picking performance considerably. Hedge funds, as well as other institutions with the firepower to trigger short squeezes, gang up on the same stocks time after time. You can see this activity in the vertical spikes that follow breakdowns of highly liquid issues, especially at popular technical levels like a neckline, round number, or triangle apex. To avoid this fate, look back at your short candidate's history in the year prior to the intended sale and observe what happened whenever support broke. You'll find one of three scenarios:

1. The technicals worked, and the price didn't pop back above new resistance (confirmation).
2. The technicals partially worked, with a quick spike above new resistance followed by another selloff (failure/confirmation).
3. The technicals failed, and short sellers were trapped in a major squeeze (failure).

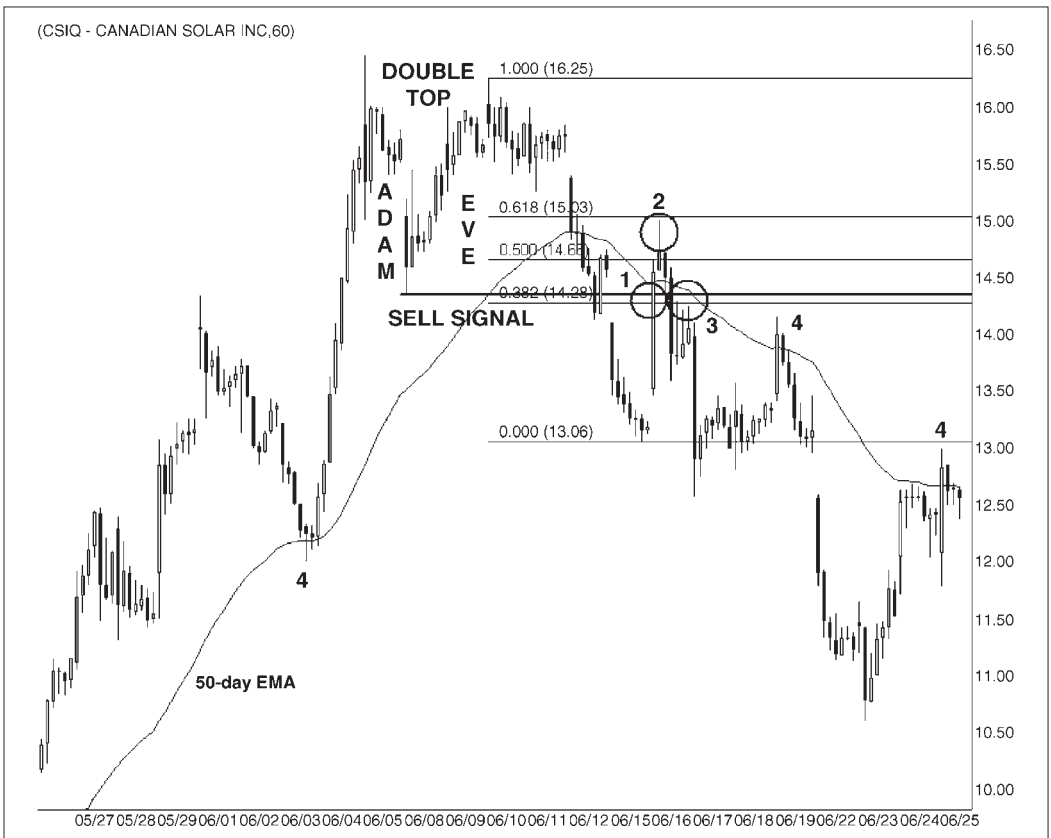
The second scenario presents the most advantageous short selling conditions. It implies that you can stand aside during the breakdown and set a short sale order above new resistance at a common level, like the 20-day SMA or a partially filled gap. Even better, you can review analog breakdowns in the prior year or two and compute the average Fibonacci retracement of bounces after the downswings that broke support. You're on the right track if computed percentages match an obvious resistance level just *above* the most recent breakdown. This investigation can also tell

you if the breakdown marks the end (climax) of a selloff or the start of a new downtrend. Zoom out as far as you can go, and look at prior periods when the market traded at or near the same price level. Simply stated, don't sell short if the instrument printed a series of notable reversals near that price. This is especially true when a particular turning point has persisted for years or decades.

The failure/confirmation scenario offers the survivalist trader excellent short sale opportunities in all time frames. In Figure 6.4, Canadian Solar carves out an Adam and Eve double top pattern on the 60-minute chart. Support at 14.28 breaks, triggering a common sell signal that most traders will use to establish short positions. The selloff pauses

FIGURE 6.4

Canadian Solar double top breakdown.



after an initial thrust, and price shoots higher in a short squeeze that lifts above the breakdown level (1), shaking out early sellers. The covering stops fall like dominoes and trigger further upside momentum, with the bounce ending at the 62% selloff retracement (2). Price then rolls over, yielding a second sell signal when it crosses the same support/resistance level as the first one (3). This “failure of a failure” signal offers more reliable trade entry for two reasons: (a) the short side is no longer overcrowded, and (b) the market tends to burn just one side of the tape before reestablishing a trend, higher or lower. Finally, note how price behavior along the 50-bar EMA (4) during the initial rally and subsequent selloff shows fractal behavior, with reversals near the moving average offering reliable entry points for short and long positions.

Ironically, it’s often too late to sell short by the time you see a selloff start to gather steam. In many cases, traders who sold short at higher levels are already looking to cover and take profits just when you’re finally convinced it’s safe to hit the order button. These better-positioned folk add considerable buying power to the market when they close out, which is why you’ll probably get crushed in a short squeeze right after you take on risk. Short sale profits also depend on the time of month. Positions entered during options expiration tend to get burned because put/call unwinding overwhelms the natural forces of supply and demand. Risk is also unnaturally high near month-end when buying power can surge due to markup activity. In a nutshell, positive seasonal forces can make a falling market float like a butterfly for a week or two. My advice during these periods is simple and to the point: don’t sell short at all unless the tape is fully engaged in a momentum bear market.

It’s urgent that traders pay close attention to the buy-sell swing when choosing to sell short. Oversold markets approaching downswing support have washed out a limited supply of sellers, which means they can rally on very little volume. To avoid this scenario, keep several overbought-oversold indicators at hand to examine your setup before entering the market. My favorite filtering tool for position short sales lasting at least one to three weeks is the smoothed 14-day Wilder’s relative strength index (RSI) described in Chapter 4. Stand aside when the indicator reaches the bottom 20% of its range and then turns higher. This roll up predicts that selling pressure is nearing its end and ready to give way to another buy swing. Markets will also snap back quickly when they stretch too far in one direction. You can measure this rubber band effect with a 20-period Bollinger Band. A simple rule: never sell short when a price bar drops 75% to

100% outside the bottom band. This extension predicts a sharp reactionary swing and a vertical squeeze against the short seller. Add high volume to a downward push through a bottom band and you have the makings of a nasty bear trap. This effect is heightened considerably when a market sells off into a horizontal band as opposed to a downsloping band.

To sum things up, let's take a giant step back and examine the dos and don'ts of successful short selling. This handful of bullet points has the power to change the weak-handed market player into a short selling gunslinger.

- **DO** short rallies, not selloffs. In other words, enter positions when the major indices are overbought and pushing into obvious resistance levels. Other short sellers, i.e., your competition, get shaken out after prices creep higher for a few days, ensuring easier profits when the market finally rolls over.
- **DON'T** jump into short sales when the index futures get hit with automated selling programs unless you're a day trader who's prepared to scale out when the algorithms push into support pivots. These programs are highly opaque, meaning you have no idea when they're going to end suddenly and give way to a substantial bounce.
- **DO** short the weakest sectors. Every market environment yields a selection of leaders and laggards. Focus your firepower on the weakest instruments that can't find buying interest, even in the most favorable conditions. You've got a helpful friend at your side when trading these perennial losers. It's called gravity.
- **DON'T** short the strongest sectors. Top picking is a loser's game, even when it's played on the pages of your favorite financial journal or newsletter. You don't know when oil, steel, or Apple will stop racing for the heavens, and neither does anyone else. So just stop guessing and stick to short plays that have already rolled over and are starting to break down.
- **DO** watch the calendar like a hawk. Seasonal events like window dressing, first day of the month, and options expiration can screw up the best short sale patterns. And don't forget the clock while you're at it. Short sales taken during the choppy midday hours are less likely to profit than first or last hour positions.
- **DON'T** short a dull market. The major indices spend four out of every five days, on average, moving sideways and shaking out

both long and short positions. It's your job to find the one day in five when the trend is alive and well. It's also your job to find the rare day when that trend is pointed lower, and not higher.

- **DO** short the indices when stocks look confused and are pulling both ways. There are frequent periods when the major averages sell off even though a variety of sectors keep running higher. Respond appropriately by selling short the weakest index funds so you don't have to guess where all the buyers are hiding.
- **DON'T** avoid big story short sales. The homebuilding and financial sectors were caught in historic bear markets in 2008, for obvious reasons. You can avoid most shakeouts in overshorted stocks and sectors by zooming out to the weekly charts and using longer-term patterns to find your sell and short cover signals.
- **DO** watch closely for false breakouts. Reliable short sale signals will trigger right after a strong stock mounts notable resistance to shake out other sellers, posts a notable high, and then breaks down through the same level. The signal is especially effective when it ties into bearish price action in longer time frames.
- **DON'T** get paranoid. Be patient while your short sale sets up for a profitable breakdown. Markets tend to fall fast and hard when they finally break but cause a ton of second-guessing while they're shaking around and probing higher levels. An even-minded personality, a good night's sleep, and a well-placed stop loss will ease the anxiety while you wait.

50-DAY MOVING AVERAGE STRATEGIES

More swing trades spin off price action at or near the 50-day moving average than anywhere else on the price chart. This might sound illogical because swing traders look for positions that will last just a few days. But so many patterns set up at this intermediate average that it becomes a focal point for all types of market entries. So, why is this popular technical setting so powerful in finding short-term trading opportunities? Perhaps it's because classic technical books and investment tomes tell readers that the 50-day moving average will support pullbacks in uptrends and resist them in downtrends. As a result, many traders try to anticipate reversals by placing limit buy or sell orders right in front of the average. This increases volatility and generates a variety of chart patterns for those still left on

the sidelines. The price level also denotes a hidden breaking point for investors, funds, and institutions. It goes something like this. Longer-term players who buy upside momentum or sell downside momentum expect a few setbacks along the way, but they don't expect a major change in trend to throw positions deep into the hole. With this in mind, the 50-day moving average pinpoints a line in the sand where these shareholders or short sellers get emotional and start to take action. The activity burst when they enter or exit the market has an unintended effect: it gives sidelined traders a great opportunity to step in and take advantage of the growing volatility.

There's endless debate about the right calculation to use for the 50-day MA, with the most common math, i.e., the simple moving average or SMA, just taking the last 50 bars and dividing by the total. It's not exactly rocket science, and technicians have tweaked the output in many ways over the years, trying to build a better mousetrap. The most popular variation is the exponential moving average (EMA). This version addresses a double count error in the original calculation and produces a reading that responds more quickly than the original math. Since the early bird tends to get the market worm, the exponential setting is now the most popular choice in the professional community. It's also the way I look at the market. So, from this point forward, the discussion will focus on the exponential moving average as opposed to the simple moving average.

Back in the glory days of the 1990s, the reaction phase after a strong breakout would find buyers well before a deep pullback, but that happens less often in our diabolical modern markets. Nowadays, many breakouts get thrown back to the 50-day EMA in a counterimpulse that wipes out the profits of bag holders chasing the initial rally and then failing to place protective stops. With this in mind, the survivalist trader exercises patience and lets the market retrace fully before taking on risk. Here's how it works. Find the 50-day EMA on a new breakout and place an alert a point or two above it. Then sit back and wait. It could be days or weeks before price hits your alert and tests the moving average, but the odds are very good that it will eventually return. Once you get your signal, look to buy when the selloff gathers steam into the moving average, or wait until the pattern in the next lower time frame—i.e., the 60-minute chart for a daily setup—carves out an upside reversal pattern.

A second trading setup that utilizes the 50-day EMA is a simple variation of the first one. The pullback after a breakout usually shows a natural support price where traders expect the market to reverse. The trendline connecting the highs in a cup and handle pattern is a good

example. But chart dynamics often place the 50-day moving average just far enough below this level that support gives way and drops price into the target, drawn to it like a moth to the flame. Most traders set their stop losses just below the natural support level and get washed out during the rinse job. They exit the trade and watch in disbelief when fresh buyers show up at the 50-day EMA, triggering a major reversal back above the contested support line.

We can see this common dynamic at work in the AK Steel breakout pattern illustrated in Figure 6.5. The stock posts a January swing high at 13 and pulls back. It rallies to within one point of this level in April, moves sideways for two weeks, and then breaks out (1). Momentum carries the

FIGURE 6.5

AK Steel magnet move.



uptrend to 16, where it stalls out and rolls over in a pullback. The stock returns to breakout support for three sessions (2) and then rolls over, hitting the 50-day EMA (3) and shooting higher immediately. Two weeks later, the recovery clears the original breakout level for the second time (4) and continues higher, confirming the new uptrend (5). These price swings might look chaotic, but consider how well they track the action-reaction-resolution cycle, outlined in Chapter 2. In this case, the fireworks are centered on the complex reaction phase, in which there's a failure swing into the 50-day EMA followed by a failure of a failure upswing over support and, finally, a rally continuation that "resolves" the breakout.

This scorched earth dynamic works just as well on the short side, where support breaks down after a long basing pattern, price thrusts lower and then bounces up through resistance, hitting the moving average from below. I guess the moral of the story is that our diabolical markets often reward those who are late to the party, rather than early. So, in anything less than ideal market conditions, we need the discipline to wait for a breakout or breakdown to fail and accelerate toward the 50-day EMA instead of jumping into the momentum chase or entering the pullback trade. This delayed execution mentality follows my long-standing advice to trade behind, ahead of, or opposed to the crowd, but never with it.

Narrow range plays at the 50-day EMA give traders extra time to enter low risk positions on either side of the market. Look for the following scenario. Price breaks down on strong volume and triggers an active selloff. The stock eventually finds support and begins a recovery back up to the 50-day EMA. This bounce stalls, and price bars contract right across the moving average. The stock then drops like a rock as selling pressure resumes with a fury. The trick is to watch this play in progress and to sell short within the narrow range bars at moving average resistance. This entry method has two advantages over waiting for the selloff to begin and then chasing the market lower. First, there are a lot of upticks in a narrow market, so you can get filled at the exact price you want. Second, the dull action lets you place a tight stop loss because any buying spike above the moving average tells you to get out of the trade.

Another useful technique is to combine two time frames on the same instrument, to pick out short- and long-side opportunities at the 50-day EMA. This 3D charting is a powerful strategy because it lets you execute big trades with very small patterns. First, locate a pullback play where the chart shows different types of support or resistance, i.e., convergence, at the same price level as the 50-day EMA. Then zoom in and watch the same stock in a shorter-term view, such as the 60-minute chart. In this

scenario, you expect a reversal at the 50-day EMA but don't know when to enter the market. The short-term chart solves your problem because it sets up its own reversal pattern. This lets you take an entry when the 60-minute pattern breaks out or breaks down. Quite often, this small-scale trend turns out to be the straw that breaks the big camel's back, cascading the larger-scale setup into a substantial rally or selloff.

The 50-day EMA works well in combination with relative strength indicators, such as Stochastics and Wilder's RSI. You'll often see the indicator hit an overbought or oversold level and then reverse just ahead of a major price swing off the big moving average. You can even apply the 50-period EMA to your intraday charts and utilize identical entry, exit, and timing strategies. The 50-period EMAs on 15-minute and 60-minute charts work in the same way as their daily cousins, with one important distinction—there's a lot more noise buried within the intraday signals. In other words, price will routinely chop through the moving average several times, even though support or resistance isn't violated. As a result, applying the indicator to intraday market analysis requires a good read of the broader charting landscape. And, in those shorter time frames, the most reliable signals come when price sells off from a much higher level, or rallies from a much lower level, into the moving average.

VOLUME

Throughout our market educations, we're taught that volume will reveal the *intention* of price. In other words, we're supposed to believe that the flow of buying and selling pressure predicts price direction, intensity, and timing, at least when it's interpreted correctly. But there's a major problem with volume in our modern diabolical markets—it doesn't tell the truth anymore. OK, that's an exaggeration to some extent. Of course there are many scenarios in which raw volume data and carefully analyzed accumulation-distribution indicators are vital to accurate price prediction. But these are the exceptions to the rule in this brave new world, where over-reliance on volume as a predictive tool will get you into a lot of trouble.

Yes, you heard me correctly. Traders should just ignore volume most of the time because it gets in the way of making money. This is a relatively new phenomenon. A few years ago, volume exhibited most of the predictive characteristics ascribed to it in the classic technical analysis books. But times have changed, with derivative instruments, dark pools, liquidity

rebates, and iceberg strategies now corrupting the predictive power of this supply-demand information. Add in the skyrocketing number of total transactions generated by orders being subdivided into micro units, and it's nearly impossible to make sense of the order flow in a typical market day, week, or month.

Consider the three volume sources that are corrupting your nightly investigation of the stock market:

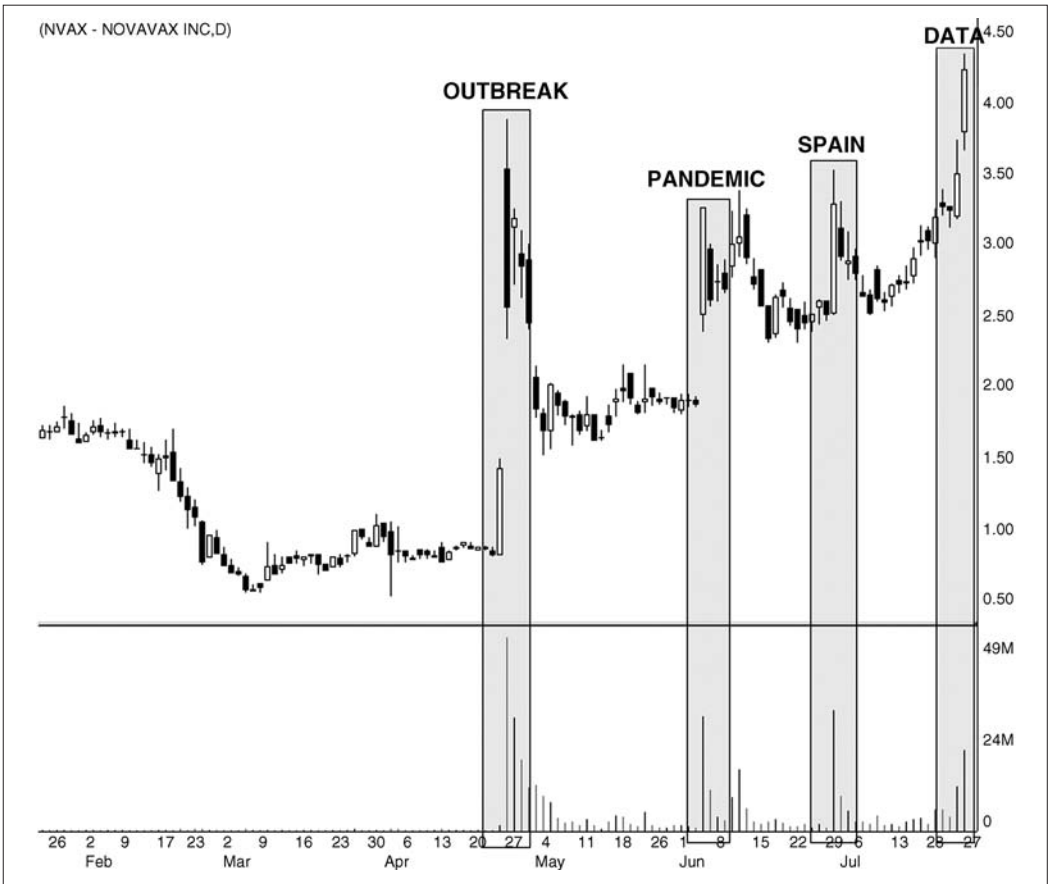
- Pension and mutual funds, which move slowly and cover their tracks, within the broad noise of daily market movement
- High frequency trading algorithms, generating profits through minor fluctuations in the bid-ask spread
- Massive programs trading index derivatives and exchange-traded funds that generate lockstep adjustments through component shares and related sectors

In order to deal with this minefield, it's best to limit your volume investigation to extreme events and price-volume correlations at swing highs and lows. Event-driven volume generates prints that fall so far outside the norm that their influence cannot be ignored in your market analysis. Even then, volume data can still be misleading. A perfect example arises when a stock gets added to the S&P 500 index. The announcement routinely generates enormous volume as index funds scramble to purchase shares, but buying in sync with the funds no longer guarantees a profit because the stock's rise can trigger a barrage of predatory algorithmic responses.

So when do you bite the bullet and actually believe the volume data you're staring at? The most reliable scenario is a high volume breakout or breakdown. Look for a minimum of three times the 60-day moving average of volume to print for that event. In addition, price should thrust away from a support-resistance level in a wide range bar. When price and volume work together in this fashion, chances are good that the emerging trend will yield to substantially higher prices or lower prices. This dynamic follows the Power Spike scan in Chapter 12 of *The Master Swing Trader*. The analysis works best on speculative stocks that are popular with the retail and momentum crowd. Most of these issues aren't components in broad index funds, so they can avoid the influence of basket strategies that force entire sectors to move in lockstep. In addition, it's easier to align high volume activity to events, milestones, and developments that are company-specific.

FIGURE 6.6

Volume patterns on speculative stocks have greater predictive value than similar activity on mid caps or blue chips. Junior biotech Novavax gaps higher on heavy volume in April after a swine flu outbreak focuses speculative attention on its influenza drug. Volume spikes again in early June when the World Health Organization gets set to declare a pandemic and again three weeks later when Spain chooses the company's drug for a nationwide vaccine program. The stock then breaks out above the April high in July, following the release of positive research data.



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On Balance Volume (OBV) is a useful predictive tool when signals are unambiguous and price sits at a key level, testing a swing high/low or a major moving average. Conversely, avoid the indicator entirely when you're lacking one or both of those environmental conditions. The most actionable data come with a strong OBV breakout or breakdown, while

price is still stuck at support-resistance. This divergence predicts that price will surge in an attempt to play catch up to the rising or falling OBV. OBV lagging a price breakout or breakdown is a divergence that predicts whipsaws will follow the trend thrust. Once again, this corresponds with the second phase of the action-reaction-resolution cycle.

As I noted in my first book, price and volume are connected by a hidden spring that allows one side to stretch away from the other until a friction point is reached, and the other side surges higher or lower to end the divergence. The problem, as I've just argued, is that this relationship has become less logical and more complicated in recent years. For this reason, most traders should just focus their undivided attention on price structure and avoid the confusion that volume brings to the table.

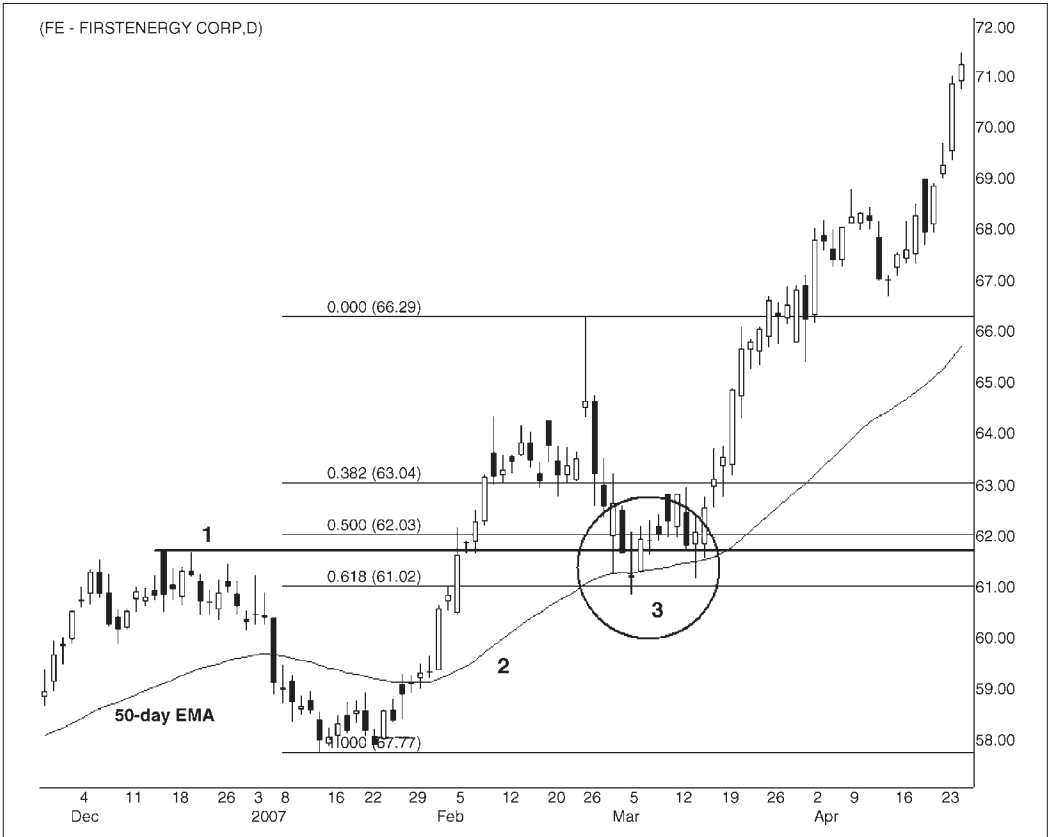
FIBONACCI PLAYS

Magic numbers, astrological dates, and prayer wheels have all been enlisted in the search for that elusive trading edge. In fact, Gann, Elliott, and other cultists spent their entire careers studying the market's mystical side and how obscure ideas have the power to tap hidden profits. Many folks still believe that Fibonacci fits into the category of market witchcraft, but this arcane science has a basis in real life fact. As we know, a twelfth century monk (later branded as Fibonacci) discovered a logical sequence that appears throughout nature. Beginning with $1 + 1$, the sum of the last two numbers that precede it generates another Fibonacci number. For example: $1 + 1 = 2$, $1 + 2 = 3$, $2 + 3 = 5$, $3 + 5 = 8$, $5 + 8 = 13$, $8 + 13 = 21$, $13 + 21 = 34$, $21 + 34 = 55$, and so on.

Major ratios between Fibonacci numbers identify natural retracement zones when markets pull back after rallies or selloffs. The most common retracements—38%, 50%, and 62%—identify price levels where many traders expect reversals and bounces to occur. For obvious reasons, these well-known inflection points generate entry and exit signals in many short-term strategies. As illustrated through numerous examples in *The Master Swing Trader*, markets swing reliably off common retracement levels as they move from support to resistance and back. But these dynamics have become harder to trade in recent years due to the growing popularity of Fibonacci as a technical tool. Not surprisingly, a growing cadre of market players take positions against key retracement levels, because they know weaker hands will jump in mindlessly when these prices get hit.

FIGURE 6.7

Cross-verification increases the odds that markets will turn at common Fibonacci retracement levels. First-Energy rallies from 58 to 66, lifting through resistance at the December high (1). It pulls back into the 62% retracement, which now aligns with the 50-day EMA (2) and support from the old high. The stock prints a bullish double bottom pattern (3) over eight trading days, adding a third level of cross-verification, and then resumes its strong uptrend.



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For example, they'll sell short when a rally pulls into the 62% Fibonacci retracement *just because* you, I, and a million other traders expect that price zone to trigger a big bounce.

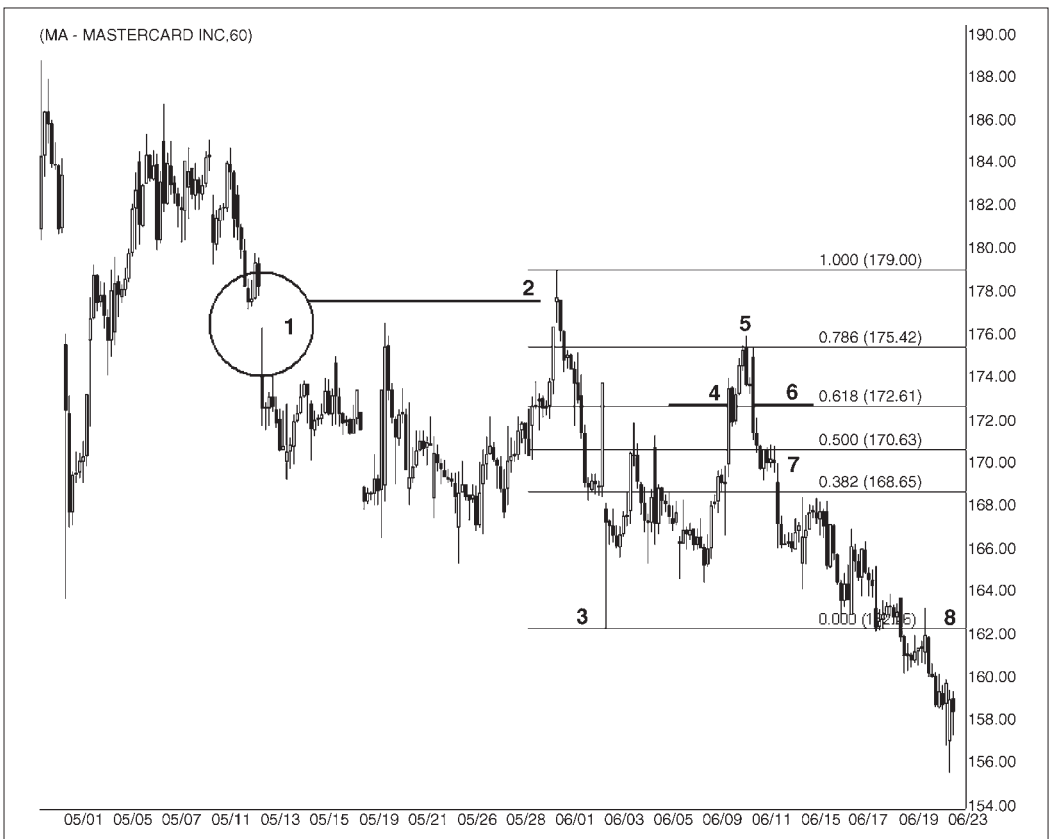
Despite the diabolical overtones, Fibonacci applications still have tremendous value as long as we apply a survivalist approach. First, never trade a Fibonacci retracement level in a vacuum, i.e., look for other forms of support or resistance to show up at the same price levels. For example, when you see a 50-day EMA, a swing high, and a six-month trendline

converge at a 62% retracement, the odds for an important reversal greatly increase. This cross-verification process identifies narrow levels where signal becomes louder than noise, making it harder for fading strategies to take hold. It's simple to apply this filtering mechanism because it's defined by a linear relationship in which each layer of cross-verification increases the odds that price will behave "as expected" when the Fibonacci level gets hit.

Second, learn to trade the Fibonacci whipsaw. Stand aside when price pulls into a deep retracement level. Let other traders take the bait and get shaken out when the instrument breaks through the magic number. Then watch until price shifts gears once again and jumps back across the contested retracement level. Use this crossing as your initial entry signal,

FIGURE 6.8

MasterCard short sale.



adding to positions on subsequent pullbacks. This setup marks yet another variation of the failure of a failure signal, in which a classic pattern fails just long enough to shake out weak hands and then magically works once again. It has a lot in common with the 50-day EMA magnet trade discussed earlier in this chapter.

The Fibonacci whipsaw trade can set up in any time frame, but it works best within a larger-scale trend, higher or lower. In Figure 6.8, MasterCard gaps down on May 13 (1) and starts to trend lower. It fills the gap (2) three weeks later and sells off to a new monthly low (3). The stock bounces near 162 and starts to retrace the prior downswing. That uptick lifts above the 62% Fibonacci retracement (4), tags the 78% retracement (5), and reverses sharply. Price drops back under the 62% retracement (6) two hours later, triggering the initial short sell signal. It then pauses at the 50% retracement (7) for another four hours, giving the trader an opportunity to add to the short position, with a stop loss just above the 62% retracement. Healthy profits can be taken when price pulls into support near 162 (8), the inception point of the prior upswing, or held in anticipation of a resumption of the larger-scale downtrend.

Finally, the survivalist trader can apply less common retracement strategies in an effort to avoid the crowd. H. M. Gartley described little-known Fibonacci relationships in his 1935 book *Profits in the Stock Market*. The Gartley Pattern relies on a 78% retracement, which offers another way to capitalize on reactionary traders caught in whipsaws at the 62% level. This classic setup, first described almost 70 years ago, works just as well now as it did during the Great Depression. You can also trade Fibonacci extensions instead of retracements. Gartley uncovered an extension trade he nicknamed the Butterfly Pattern. This is a complex formation that carries price 27% past a 100% retracement before it reverses. Got that?

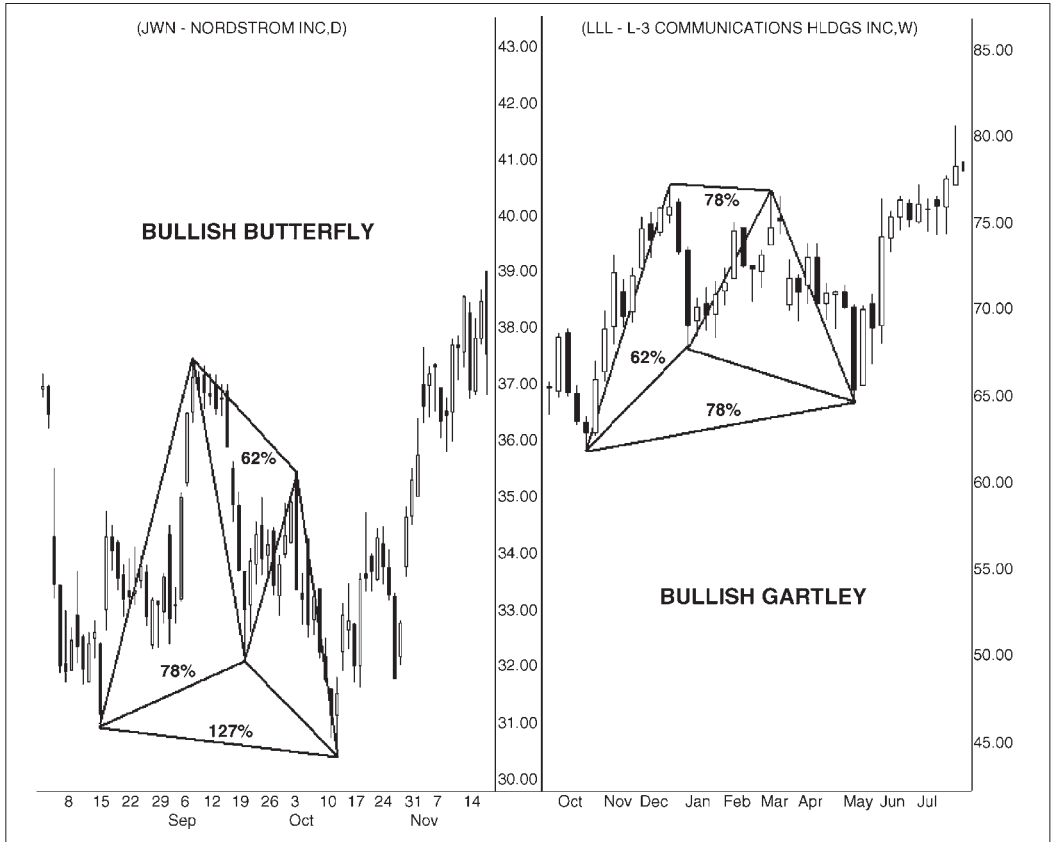
The infinite combinations of ratios and waves can be confusing if you're unfamiliar with these old patterns, but that's exactly the point here. The real power in applying convoluted Fibonacci mathematics is its ability to confuse most traders, which is perfect because the markets rarely reward the majority.

COUNTERMARKET PLAYS

The most common market strategies trade in the direction of the most obvious trend, but you also take the less-traveled path and enter positions

FIGURE 6.9

Traders have relied on complex Fibonacci patterns for decades, but many of these forgotten gems are still unknown to the majority of traders. The Gartley and Butterfly patterns spin off proportional swings within trading ranges, predicting subsequent breakouts and breakdowns in the intraday, daily, and weekly time frames. These patterns work just as well on the long side as the short side. Visually, they're easy to locate because they look like Ws and inverted Ws.



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against the trend. In fact, fading the tape has been a very profitable tactic in the last decade. The challenge lies in entry timing because jumping in against major order flow without careful planning will cut you to shreds. The significance of the buy-sell swing can't be overstated in this regard because it provides the information you'll need to establish a profitable countertrend position. Also consider how pattern failure plays into the establishment of tradable swing highs and lows. Simply stated, nearly all reversals begin at a high print just above a notable range or a low print

just below a notable range. In other words, the trending equity, index, or futures contract consolidates near a high or low while the crowd waits to profit from the next move in the same direction as the trend. The breakout or breakdown finally unfolds, drawing in sidelined cash, but then reverses and whips back through range support in an uptrend or range resistance in a downtrend.

This is an especially notorious phenomenon in the index futures, which rarely embark on a countertrend swing without a final sucker punch to the guts of trend traders. The near certainty that a swing will print a final trap before it reverses gives the survivalist trader a powerful edge, as long as discipline is exercised while the overextended market carves out a last gasp rally or selloff. It's tough emotionally because, by that time, our neurons have been tricked into a simple trend-following mentality by the sheer persistence of the prevailing swing.

There are three types of countertrend plays. The first involves any trade that goes against the long-term moving averages. The second is a high volatility play where you sell short at the extremes of a vertical rally or catch a falling knife in a plunging market. The last strategy, which requires fewer antacids, just fades support or resistance within a well-defined trading range. Each of these tactics requires a different mindset and reward:risk calculation. In particular, trading against high volatility can be very dangerous without adequate defensive measures. However, despite the obvious risks, each countertrend strategy has an important place in the survivalist trader's playbook.

Newer traders should concentrate on simple rangebound plays and avoid the more dangerous countertrend tactics. But as experience grows, moving against the tide will become more and more irresistible. In fact, some market players are naturally hardwired to play the countertrend more effectively than the trend. However, even these contrary folks face a steep learning curve that includes ill-advised positions and a few major catastrophes. This is especially true when shorting big rallies or knife-catching big selloffs. Simple technical strategies lose their effectiveness in those highly volatile markets, except in longer time frames. In other words, big rallies may carry well above natural extensions and price targets, while big selloffs don't end until the last dip buyer gets crushed like a bug.

A long trade under the 200-day moving average or a short sale above it is always a countertrend position that requires a more defensive approach. Simply stated, bulls live above the 200-day, while bears live below it. Since the major indices have spent many years of the last decade grinding under this moving average, we're all guilty of trading

countertrend long positions. Not surprisingly, I've been forced to adjust my market scans repeatedly since the 2000 bubble top to include long-side scenarios I would have avoided completely back in the 1990s. One of the most common countertrend plays, which works extremely well after a bear market, is the breakout from a deep basing pattern and a pullback to support. Traders bought these patterns without hesitation in 2003 and 2009 while keeping one eye on overhead resistance. Realistically, the 50-day EMA does a better job than the 200-day EMA telling us when to go with the flow and when to go countertrend. Logically, it makes sense to take long positions above this intermediate moving average and short sales below it.

Of course, we're all attracted to falling knives, but it's painfully easy to get clobbered on these volatile trades without a good strategy and solid risk management. No, it isn't that difficult to predict where a plunging stock should stop falling by using support-resistance and retracement analysis. The problem lies in the explosive tape. In shorter time frames, a volatile selloff can drop through a major price floor, undercut support by several points, and then leap higher, leaving behind a long candle shadow and a graveyard of logical stop losses.

So how can you manage these high-risk, high-reward setups? Two techniques will keep you out of most trouble and let you catch a profitable chunk of these violent markets:

- Break up your position into tiered limit orders on both sides of the expected reversal level. Then place a stop loss just below the last order, and exit the entire position if price drops that far.
- Place a single order just below the level you think price might hit in an extreme situation. This outer limit often identifies the exact turning point because it washes out everyone else, which is usually a requirement for a major reversal.

Rangebound markets offer classic countertrend swing plays, using support-resistance boundaries to buy weakness and sell strength. It's best to let congestion set up for a while before you trade these patterns, because most whipsaws come in the early stages of range development. The best countertrend trades come in the range's *sweet spot*, which happens just before price action gets dull and lifeless, ahead of the next breakout or breakdown. This type of countertrend entry is always price-sensitive because there's a limited amount of reward from one side of the pattern to the other.

Here are a few tips on this classic countertrend strategy:

- Set your stop loss just outside support or resistance. Risk is very small when you enter a trade just behind this intended exit price.
- Focus your entry near a single price level, and then stick to it.
- Don't chase positions at any time because they need to execute with minimum slippage in order to keep reward:risk in your favor.
- Try to get it right the first time because too many reentries, triggered by poor timing, will eat up the trade's profitability.

FIGURE 6.10

Two entry strategies work with falling knives, but aggressive risk management is required in both approaches. Fuqi International rallies from 4.66 to 7.75, posting a continuation gap below the 50% retracement level. It then sells off, yielding the falling knife setup outlined in the Massey Energy trade in Chapter 1. The first strategy enters small positions on either side of the gap (1 and 2), placing a stop loss (3) under the last entry. Ironically, the stop price is the entry trigger for the second strategy, because it's located at the level where most traders have given up.



- Once established, the position should be held until price pulls into the other side of the trading range. Then take profits and look for an entry in the opposite direction.

FIRST HOUR RANGE BREAKS

The opening bell brings fresh conflict, with buyers and sellers brawling for control of daily price direction. This battle of wills often generates a first hour range that sets boundaries for larger-scale rallies or selloffs later in the session. Trading the breakout or breakdown from this sideways pattern is an effective technique to capture short-term profits.

There are four key elements in a first hour range breakout and breakdown strategy:

1. **Instrument.** The strategy works best in highly liquid markets, so stick with stocks that trade over 5 million shares per day on average. Even better, use exchange-traded funds that correlate with a major index or sector because they're less vulnerable to news shocks. Build a watch list of possible candidates that you can keep from day to day. Populate your list with groups that don't all move in the same direction at the same time.
2. **Entry price.** Buy when price rallies above the high of the first hour range, or sell short when it falls under the range low. Add a few cents to the upper and lower end of the range when establishing your entry price in order to avoid whipsaws. Realistically, the entry signal might come right after the first hour or not until much later in the session. This is a short-term play, so full position size should be taken immediately rather than scaling in with smaller shares. After execution, look for the trade to move into a profit quickly. When it doesn't, the odds for a whipsaw increase geometrically.
3. **Stop loss.** Calculate the height of the first hour range, placing a stop loss 15% to 20% under the high for a breakout, or above the low for a breakdown. For example, a stock trades from a low of 22 to a high of 24 in the first hour. For a breakout, place the stop between 23.60 and 23.70. For a breakdown, place the stop between 22.30 and 22.40. Mental stops aren't recommended because you're working in close quarters where a reversal can come quickly and you might not have enough time to react.
4. **Profit target.** Identify your profit target by looking at the last two days of 15-minute price bars and finding the last major swing

in that direction. If there's no swing to work with, use a tight trailing stop and get out at the close if the stop doesn't get hit first. Make sure there's enough profit potential to make the position worthwhile. If there isn't, do not take the trade. A simple rule of thumb: look for trades in which the realized profit will be at least three times the risk of price rolling over and triggering the stop. For example, you enter a trade at 30, with a profit target at 30.70 and a stop loss at 29.80. The potential 70-cent gain is 3½ times the potential 20-cent loss.

Wait on the sidelines through the first 30 minutes of the session, and draw horizontal trendlines on a 5-minute chart that correspond with the high and low over that period. Then, adjust those lines in the next 30 minutes to establish the first hour range. Continue to use the 5-minute chart for trade management after picking out your intended profit target. Before entry, confirm that the pattern will actually support your intended strategy. The first hour range is established by swings in both directions. Swing levels aren't measured until there is a counterswing that generates a 5-minute high or low. You'll find that many stocks are already trending at the end of the first hour and not swinging back and forth. These issues should not be traded using this strategy.

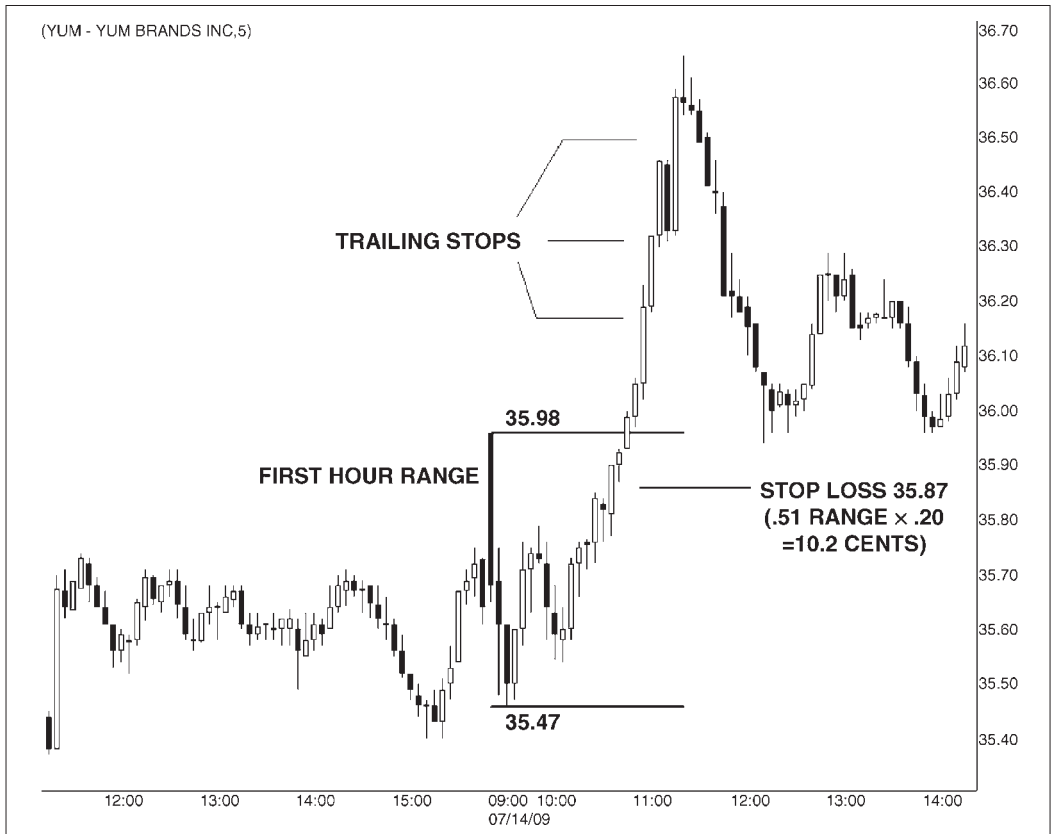
BILATERAL ENTRY

You can double your opportunities with bilateral trade setups. Start by overcoming your directional bias when you look at a price pattern. Although you might see it in your head as a long or a short opportunity, there's a good chance it will work in either direction. The trick with this strategy is to let the price action tell you which way to go. It works like this. Many consolidation patterns hit balance points in their evolution in which they generate equal odds of a breakout or a breakdown. When support and resistance levels are narrow and well defined, traders can establish bilateral strategies that take advantage of the developing trend, whichever way it finally breaks. It's a relatively simple process that triggers a long entry if price rallies above resistance and a short entry if price sells off through support.

Each side of a bilateral setup candidate carries a different reward:risk, with one side usually showing more profit potential than the other side. This can be frustrating because the calculation is independent of the odds that either outcome will actually take place. So, for example, you might

FIGURE 6.11

The first hour breakout strategy works especially well when opening volatility is higher than normal. Yum! Brands gaps up to 35.98 and then drops to 35.47. The 51-cent range holds until late morning, when a vertical breakout lifts the stock nearly a point over early resistance. A 20% stop placed at 35.87 manages the trade well, while a trailing stop protects profits during the strong uptrend.

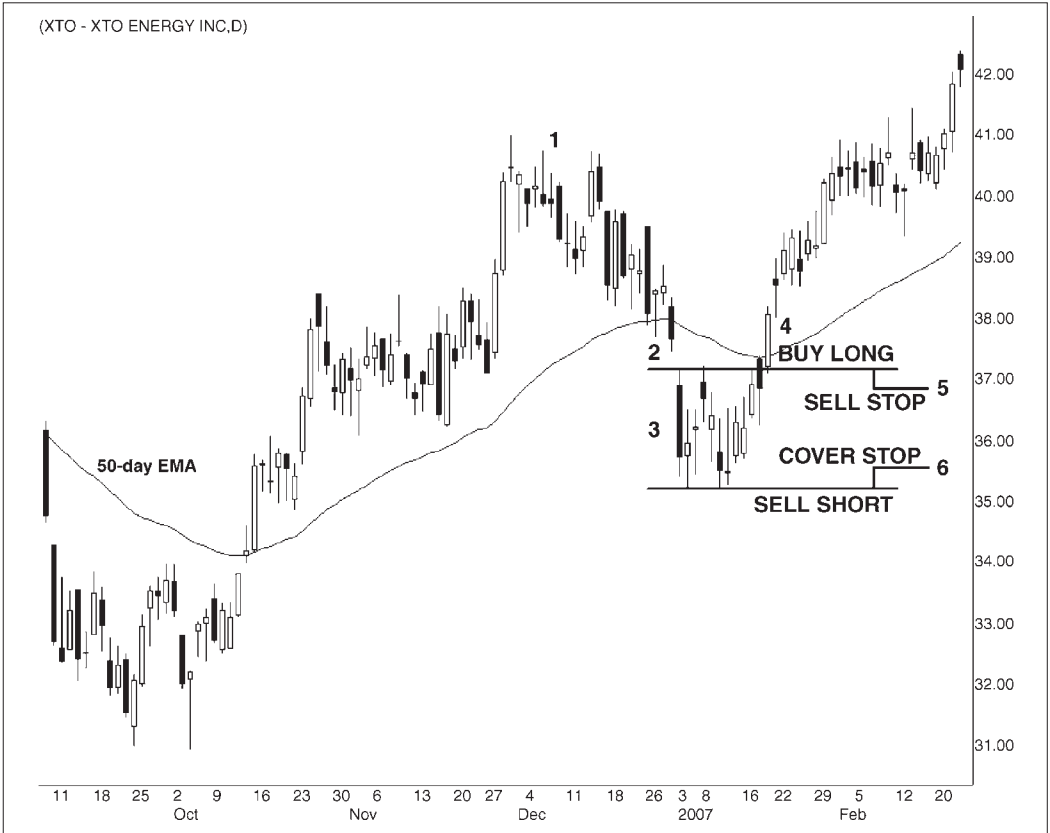


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have a high-odds long-side setup with absolutely no reward potential, or a low-odds short-side setup that would yield windfall profits if it ever happened. The trick with bilateral strategies is to locate patterns that are equally weighted in both odds and reward potential. Price triggers complicate bilateral entry even further. Entry signals come in all varieties, with the most profitable ones ringing loud bells at narrow price levels. Just like disparities in reward potential and trade odds, one side will usually bark louder than the other when price hits the associated trigger. Traders

FIGURE 6.12

XTO Energy bilateral setup.



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need to overcome this limitation by finding patterns with well-organized inflection points on both sides.

To sum up, an effective bilateral strategy requires three elements: well-defined support-resistance, favorable reward:risk on both sides of the equation, and clean price triggers on both sides of the equation. It sounds simple enough, and it really is. The difficulty lies in our ability to control bias and let the market tell us which way to go. Not surprisingly, the best trade is usually in the direction that's opposite to our bias. In other words, the majority is ready to pile in one way, but the biggest profit comes from

an unexpected signal in the opposite direction. Realistically, it can take practice for the biased trader to keep an open mind and let the price action dictate position entry, long or short. But the discipline pays off because, once again, it helps us to follow the classic wisdom “to trade what we see and not what we believe.”

In Figure 6.12, XTO Energy rallies from 31 to 41 and starts to pull back (1). It drops into support at the 50-day EMA and gaps through that level in mid-December (2). The stock then eases into a trading range (3), with support above 35 and resistance above 37. This price action establishes a bilateral setup because a rally out of the rectangle pattern will trigger a failure of a failure buy signal, while a selloff will confirm the breakdown, issue a sell signal, and set up a test of the swing low at 31. Limit orders can be placed just outside the trading range, triggering a buy near 37.40 or a short sale near 34.80. Alternatively, the trader can just stalk the pattern in real time and enter as soon as one side gives way. In this case, the stock surges out of the rectangle (4) in mid-January and climbs back above the 50-day EMA, triggering a buy signal ahead of a strong recovery.

Compute the stop loss using the same technique as the first hour breakout-breakdown strategy. Calculate 15% to 20% of the pattern width and place the stop loss that far behind the breakout or breakdown level. In this example, the rectangle is about two points wide, with 15% to 20% of the width equaling 30 to 40 cents. Using this calculation, the trader places a stop loss near 36.80 (5) for a long position or near 35.50 (6) for a short position.

THE REAL WORLD: PARANOIA AND PROSPERITY

It pays to wait until all your ducks line up in a neat little row when you have no skin in the game.

A barrage of selling pressure hit the fertilizer stocks on July 22 in response to falling potash prices. The entire sector had been underperforming the broad market for weeks, so the minipanic at the opening bell wasn't too surprising. Component issues gapped down hard that morning, with many dropping more than 5% right out of the gate. The air pocket tossed overnight shareholders into a deep dark hole, forcing them to deal with shock losses at the expense of other forces moving the market that

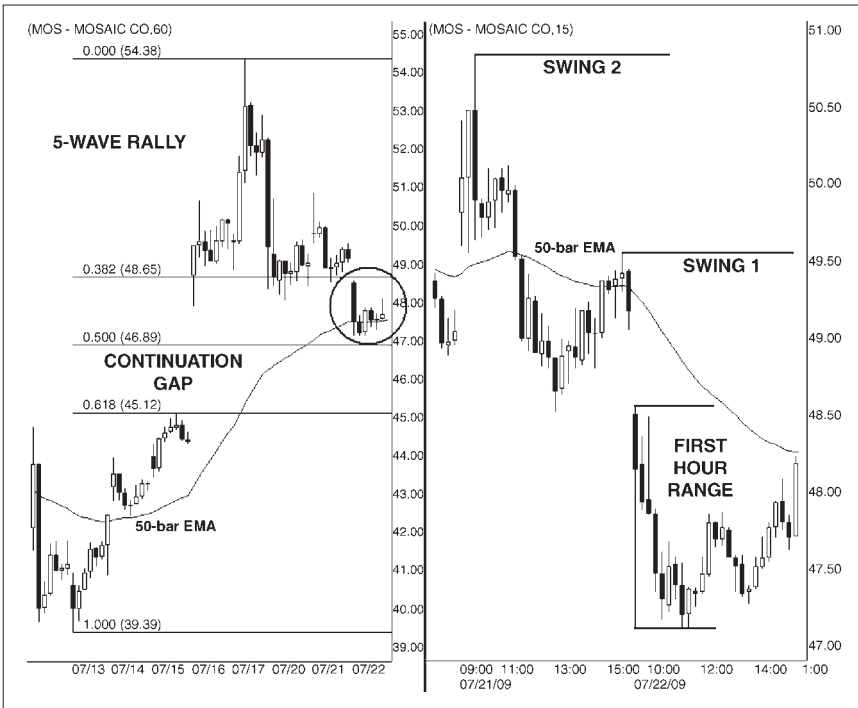
day. For those on the sidelines, however, the surge in volatility set off a positive spiral that generated an excellent profit opportunity.

Consider the psychological divide between unfortunate longs stuck in their plunging stocks and folks sitting on the sidelines, looking for a good trade. Both groups are staring at the same patterns and indicators, but the shareholders can't see straight because the losses overwhelm their objectivity and induce a paranoid state that envisions the worst possible outcome. Of course, this isn't quite true because every swing, higher or lower, yields a corresponding set of odds that defines the likelihood of further upside or downside.

It's a different story for sidelined market players, who can examine the shock event objectively and look for inflection points that support a variety of plans and strategies, as seen in Figure 6.13. Getting started,

FIGURE 6.13

The fertilizer selloff yields unexpected opportunities.



you pull up 60- and 15-minute charts on Mosaic, a sector blue chip, and notice how the price swing that preceded the selloff carved out a well-organized Elliott five-wave rally set, with a big continuation gap between 45 and 48. The morning decline has dropped price through the 38% retracement of that uptrend and into the continuation gap's broad range. However, there's no automatic long-side signal here, as in prior examples, because the setup doesn't work when price *gaps through a gap* to get to the entry trigger. However, despite the downward pressure, there are several technical aspects that make this pattern interesting on the long side. Not pictured here, the 50-day EMA cuts right through the continuation gap, while the morning selloff has dropped price into that intermediate support level. This yields a potential turning point in which downward momentum is running straight into a solid price floor. Over the years, I've dubbed this two-sided scenario as a "rock and a hard place" pattern, in which the eventual breakout or breakdown will be very strong because it traps one side of an emotionally charged market.

Now look how the 50-bar EMAs are coming into play. These levels mark support on the 60-minute chart and resistance on the 15-minute chart. So we now have three incarnations of this moving average sitting at key prices, yielding a technical convergence, even though the levels mark out both support and resistance, depending on time frame. More importantly, the moving averages themselves show a bullish divergence because price is above the moving average on the two longer time frames but under the moving average on the shortest time frame. This follows my observation that trend direction flows downhill, with longer time frames taking priority over shorter time frames. This divergence won't resolve itself until all three moving averages provide either support or resistance.

You now mark out the first hour range, which holds through the entire session. By day's end, the conflicting elements resolve into the outline of a bilateral setup that will trigger on a breakout or breakdown of that early range. This is another convergence because signals on the 15-minute chart are lining up perfectly with signals in longer time frames. Specifically, the stock is at 50-day EMA support while price is caught between the 38% and 50% selloff retracements. A first hour range breakout will mount the 38% retracement, triggering a failure of a failure buy signal, while a breakdown will violate the 50-day EMA and 50% retracement, triggering a sell signal.

This alignment increases the odds that a breakout will yield an uptick that reaches the profit target at Swing 1, at a minimum. Meanwhile, there's

nothing but thin air below the first hour range, indicating a breakdown could drop all the way to 45 and fill the 60-minute continuation gap. With this in mind, orders are placed at both ends of the pattern, ready to trigger on a break in either direction. The placement of the 50-bar EMA on the 15-minute chart is extremely favorable for the long-side trigger because it supports an entry before price actually rallies above pattern resistance at 48.50. It also solves the thorny issue of gap and Fibonacci resistance near 49. In other words, you expect momentum out of a first hour range breakout to lift price above resistance, but getting it wrong could be costly. Trade entry just above the 50-bar EMA reduces that risk substantially because it lets you get positioned, with a 25- to 30-cent profit, before the breakout unfolds.

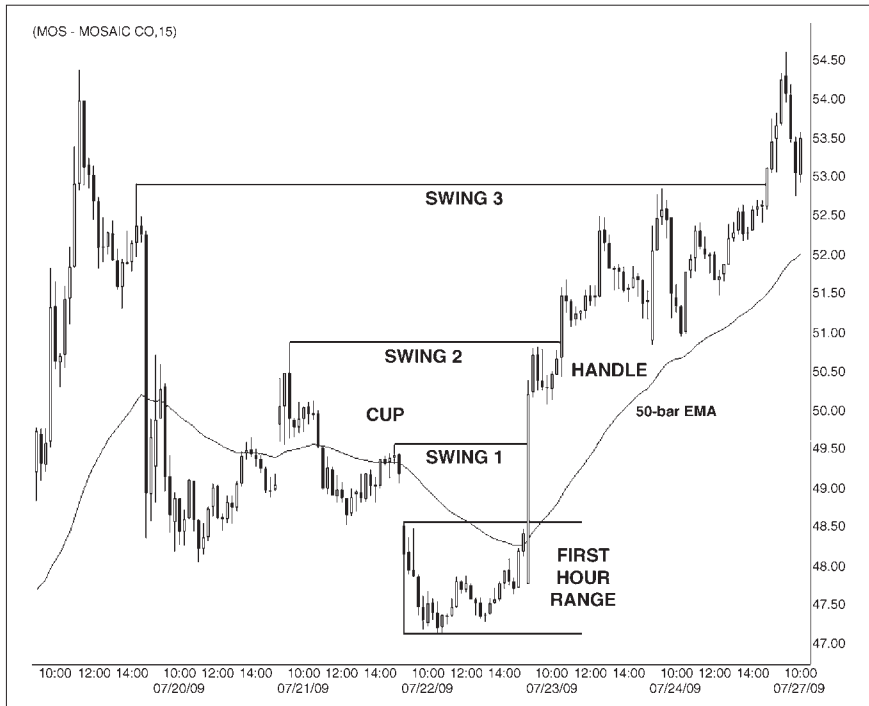
The trick now is to exercise patience and to wait for the price action to “speak for itself.” This is easier said than done because the entire session has passed without a breakout or breakdown. In truth, the markets tell many tales one lonely chapter at a time. In other words, a financial instrument does someone good or bad at the opening bell and spends the rest of the session forcing traders to guess what it actually means. They expect resolution by the close, which is an obvious fulfillment cycle, but the diabolical market forces them to wait overnight or even a week before the ticker tape finally addresses their curiosity with a follow-through rally or selloff.

In Figure 6.14, Mosaic gaps down nearly a point the next morning, staying within the prior day’s first hour range, and then shoots higher, breaking above the 50-bar EMA in the first 15 minutes of the new session. This signals the long-side entry, with a stop placed on the other side of the moving average. The new support level never gets tested because the stock shoots higher immediately and rallies through the Swing 1 pivot, which marks the first profit target. You now have two equally pleasant choices: take the profits right there, or defer to the positive price action. From a tape-reading standpoint, the power of the uptrend to cut through the initial swing pivot like butter is a bullish convergence that predicts even higher prices. This observation supports a more aggressive approach, with an eye on the Swing 2 pivot, near 51. The stock reaches that level in the next 15 minutes, offering a more advantageous exit.

Momentum now eases up, indicating that remaining shares need to be sold because the odds favor a pullback. Back on the sidelines, you notice that price is holding up extremely well, hovering near the

FIGURE 6.14

Real-time management makes or breaks the Mosaic trade.



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intraday high for over an hour. This price action generates a small-scale cup and handle breakout pattern that signals another long-side entry in the late morning. The stock then surges higher in a series of waves that carry through to the end of the session. As the day progresses, however, reward:risk starts to deteriorate and turn against the trader. Price is approaching the Swing 3 pivot slowly, and pullbacks are getting deeper and more volatile. In addition, the trend is running out of time because anything can happen overnight, especially with a commodity-based instrument that's subject to worldwide news shocks.

Wisely, you decide to close out the trade, add up the excellent profits, and call it a very good day.

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FOUR

P A R T

MANAGING OPPORTUNITY

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7

C H A P T E R

MARKET ENTRY

Risking money in the financial markets changes everything. Your body chemistry changes, as do your attention span, willpower, emotional composition, and interpersonal relationships. Just ask the millions of traders who have lied to their spouses after a particularly bad day, too afraid to admit their failure or unexpected damage to the family accounts. This Jekyll and Hyde transformation illustrates why paper trading is a nearly pointless exercise for new market aspirants. Trading exposes most folks to things about themselves they really don't want to know. It's a force-fed truth serum that makes long-term success in the markets especially difficult for life's overachievers, who have reached alpha status in their primary careers, social encounters, and intellectual pursuits. That's why I tell doctors, engineers, and architects they're less likely to succeed in the trading game than a high school dropout with an intuitive feel for the ticker tape and a healthy detachment toward risk.

To minimize the psychic impact of risk taking, traders need to match their positions, exposures, and markets to their personalities and

lifestyles. This isn't an easy task because there is often a massive disconnect between who we think we are and who we really are. We're also lazy as hell, believing we can skip a few steps on the road to trading profitability and go straight for the cheese, never noticing the spring-loaded mousetrap that's standing in our way. As a result, newbie traders create all sorts of extraneous problems that make long-term success doubly difficult, robbing them of the time and energy they'll need to focus on strategy and position management.

Decide right now whether you're a speculator or just a spectator. Simply stated, someone on the sidelines will see things much differently from a trader who's risking real money in real-life situations. To make matters worse, many traders continue to think and act like spectators long after they've assumed position risk. Playing the short side in a secular downtrend offers a perfect example. There are good reasons to hate the market when a financial system blows up or a tech bubble bursts, but you can make money on the short side only when your positions go down, not up, which they'll do through long stretches of every bear market. It's especially tough because we live in an Internet-driven society filled with keyboard jockeys spouting a thousand worthless opinions just to see their words in print.

Spectators sit on the sidelines and wear opinions like hats, while speculators take those opinions and assume financial, physical, and emotional risk. Opinions require little more than a loud voice or a cynical writing style, while real-life speculation demands courage, capital, and commitment. Spectators rationalize their failures and assign responsibility to the likes of Madoff or overleveraged exchange-traded funds. Speculators realize there are no demons outside of themselves and their shortcomings in personal discipline. They see all news, good or bad, as an opportunity to profit and understand that capitalism has its own self-correcting mechanisms. Spectators may feel good and wise, but they're just engaging in blatant self-abuse. After all, why bother with the financial markets if the purpose isn't to make money? Clearly, there are far better ways to spend our time than worrying about something we have no stake in.

Market chitchat during volatile periods generates secondary rewards, like improved self-esteem, a sense of power, and brownie points with your peers, but are you talking your book during those opportune times—or just talking? In other words, are you buying, selling, or too paralyzed by fear when the markets are really moving to do anything at all? If you're sitting on the sidelines twiddling your thumbs, understand that

smarter folks are counting on that crazy volatility to pay the bills, and you could be doing exactly the same thing if you weren't caught in the spectator's game.

I've been really upset about the financial markets only one time in the last two decades. It happened after the American government closed down Wall Street, following the September 11 tragedy. That historic event did the one thing I couldn't handle emotionally at the time, i.e., take away the source of my livelihood. Contrast those shut doors with the scandals, blowups, and SEC rule changes that come along periodically to shake up the market tree. No matter how awful or disturbing they might be, at least the exchanges are now open for business each day and willing to execute your trades.

In the final analysis, the transition from market opinion maker into profitable trader requires a major shift in consciousness that begins when you shut down pointless belief systems and exchange them for a razorlike focus on price action as it emanates from the charts or ticker tape. If you can do that one thing properly and with no bias, you can earn a great living as a trader.

MARGIN AND CAPITALIZATION

We define risk in a new opportunity, enter the market, and carry the position to an eventual profit or loss. Of course, there are infinite variables for each element of this deceptively simple workflow. Our first task is to choose whether to trade stocks, futures, or currencies, accepting the risk profile that each instrument will bring to the table. Our next decision must deal with the thorny issue of time management. Will we become day traders and close positions at the end of the session, or position traders and expose ourselves to the risk of overnight reversals? Finally, our workflow needs to perform a sober reality check. Do our lifestyles and emotional makeup favor one approach over another, and will we match those tendencies to our market activities or fight them every step of the way?

The amount of free flow capital we have to place at risk dictates many of our pre-entry trade decisions. This limitation forces us into the thorny subject of retirement accounts, which often make up the bulk of liquidity for seniors and middle-aged adults. This is no big deal for responsible market players who will protect their nest eggs at all costs, but it's absolutely destructive for yo-yo traders, with histories of big blowups and

catastrophic losses. These folks in particular are better off avoiding the trading game entirely than trying to turn a small retirement account into a working fortune. At least our Keoghs, IRAs, and SEPs are cash accounts, which offer a measure of protection against our darker instincts.

No similar safety net exists in a traditional margin account, which becomes ground zero for excessive risk taking. Margin strategies have become even more dangerous in our modern environment, if that's possible, through the addition of 4:1 intraday buying power in a typical equity account and 10:1 or more in a typical futures account. To make matters worse, newbie traders come into the game believing, falsely, they need to use 100% of that margin on every position in order to make money.

In reality, margin is just another trading tool. Many times our sound risk analysis doesn't support the use of margin because it increases total risk above the maximum loss that can be absorbed by our working strategy or edge. In addition, margin implies a level of certainty that's hard to achieve in our trades because we're managing various shades of gray as opposed to distinct layers of black and white. This element of chaos demands the use of multilayered "collaring" techniques. At its core, collaring determines the aggressive or defensive posture we initiate during the market day, based on overall risk, movement of the major averages, and affinity of the ticker tape with our predefined edge. For example, the long side in a falling market requires defensive collaring, at least until an instrument pulls into a support zone where a pullback play can be considered. Alternatively, a rising market for a trend follower offers ideal conditions to make money, supporting an aggressive collar, which may include more expansive use of margin and even options plays. Look in Part Six for a detailed discussion on collaring techniques.

Margin becomes power in highly favorable markets. The 2003 and 2009 recoveries, as well as the tech, home-building, and commodity bubbles, offered nearly ideal conditions for traders to ante up and turn margin into profit. Our only challenge during these good times lies in recognizing when low-hanging fruit is hanging on the branch and waiting to be picked. However, regardless of market conditions, margin use should be avoided entirely until the trader establishes a track record that shows consistent profits. In addition, the typical monthly statement should reflect just moderate losses, with few spikes or catastrophes. In other words, performance over time indicates the trader is actually missing out on opportunities by not taking bigger risks and the firepower that comes with margin use.

Day trading equities increases margin capacity, which works extremely well for the select minority of traders who have cracked the

code of the intraday markets. Not surprisingly, it's a total disaster for anyone aspiring to be a day trader but lacking the risk management skills required to survive and prosper in that volatile arena. Consider that 4:1 intraday margin was a trade-off by the SEC after the establishment of the pattern day trading (PDT) rule. The unfortunate decree assumes that more liquid individuals have greater skills to assume intraday risk than poorer traders, but that's questionable. In any case, my advice to aspiring day traders is the same advice I give to multiday swing traders—don't use margin until you can prove beyond a reasonable doubt that you're actually losing money by not using it.

Of course, it's nearly impossible for futures or currency traders to avoid margin. It's less of an issue for futures traders because those folks understand that extensive skills and risk management are an absolute minimum for survival. Unfortunately, nothing could be further from the truth in the currency markets. This worldwide market segment boomed in the United States following the PDT rule. Undercapitalized traders had no choice but to seek out new venues at that time because they were getting their accounts frozen for violating the new rule's capital restrictions. In turn, this exodus triggered a massive bull market for the forex broker industry. Hundreds of shaky operations sprang up overnight, all of them willing to open accounts with as little as \$1,500 equity. The new opportunity attracted a legion of underskilled and undercapitalized traders looking for a way to turn their small stake into a big fortune. Unfortunately, lax regulation in the United States has allowed these brokers to act as market makers, taking the other side of clientele positions. This inherent conflict of interest continues unabated, robbing trading accounts as quickly as they're created.

Currency traders need margin to gain leverage over relatively small oscillations in the currency pairs. But that's nearly suicidal for small accounts because risk functions as a percentage of total swing within an equity curve. In other words, a \$100,000 account margined at 2:1 can take a 3% price swing and lose \$6,000, or 6% of the account. A \$1,500 currency account margined at 20:1 will lose \$900 on an identical swing, or 60% of the account. This exposure demands that forex traders without proven skills reduce their margin use. Ironically, they're the group most likely to lack a comprehensive understanding of this risk category.

It's hard to tell traders not to trade because they have 100% chance of failure, but that's exactly my advice to undercapitalized currency traders. It's far better to wait and build a working stake than to take inadequate funds and try to become a millionaire at a modern-day bucket shop. Patience will eventually pay off because well-capitalized currency trading

works just as well as other liquid markets, at least when the house isn't stacked against you. To this end, currency futures offer a better alternative because they're more tightly regulated, ensuring that the price you see is the price you'll get when you hit the magic button.

New traders might need months or years to scrape together enough capital to open their first equity accounts, but it's a different game entirely after you've made your fortune through career, inheritance, or just plain good luck. Let's say you've achieved typical net worth for a 40-year-old in a technical or professional career. You've built a variety of investments through a number of brokers, and now you want to improve your returns with swing trading. Sadly, poor capital allocation in these fortunate circumstances can place your entire nest egg at risk. In that regard, I recall a woman being interviewed when the financial news was doing a report on folks who lost money when the tech bubble burst. I almost fell out of my chair when this individual told the reporter she had lost more than \$7 million through day trading. How absolutely insane! It doesn't take a rocket scientist to understand that you don't day trade if you have \$7 million. In fact, you shouldn't be trading at all, unless it's someone else's money, because that level of wealth is more conducive to portfolio management than to trading or technical analysis. Besides, someone who risks \$7 million due to personal greed or plain ignorance doesn't belong in the markets in the first place.

It's your responsibility to protect the family fortune at all costs. Without exception, a good portion of your wealth needs to stay off limits to your trading endeavors, at least for the first five years. The bottom line: you've got a family to feed, a mortgage to pay, and kids to put through school. It's just plain foolish to risk the cash you need to pay those bills because you think you're going to double or triple it with a few big trades. Instead, set aside capital by opening accounts that align with different goals and opportunities. Fund them with cash you can afford to lose, and not a single penny more. The odds suggest only one or two traders out of ten will succeed in the long run. Without a proven track record, your desire to trade successfully may never overcome your lack of skill or the demands of your nonmarket life.

Fund the main account with enough money to address the PDT rule, even if you don't intend to flip intraday positions. Current settlement rules are so convoluted that you need a comfortable cushion above the \$25,000 minimum requirement. I recommend at least \$50,000 to start. Open this account with a direct access broker rather than a discount broker. This is the arena where you'll make the majority of your trades. It's also the place where you're going to lose the most money in the shortest time

period. Stating the obvious, your account interface needs to be open and right in front of your nose from the premarket through the postmarket sessions.

I don't recommend a discount broker for your main account because these brokers are too expensive, they treat settlement unfavorably, and they limit access outside of regular market hours. However, these companies serve an important purpose for secondary accounts, i.e., they can be used for hands-off trades where positions will swing through greater price ranges without stopping out. At its core, this is a proactive way of using benign neglect to overcome risk aversion. A second purpose for this account requires solid market-timing skills. Use it as a cash horde for those rare times when the broad market or specific sectors are running in very strong trends and you want to "park" a chunk of working capital.

Many well-heeled individuals set aside a tiny portion of their big family accounts for trading and mentally keep their fingers off the mother lode. Unfortunately, this just doesn't work, except as a fun hobby. The trader's goal is to make money through market speculation, but this scenario masks poor performance due to passive returns emanating from the big chunk of capital. In other words, dividends, interest, and long-term investments may cover up your trading losses, making you feel like a winner when you're not. Realistically, there's a level of capital accumulation where trading prospects diminish considerably. Successful traders are driven individuals who are fully market-focused. It's tough to achieve this level of commitment when personal wealth already provides life's greater gifts. This capital cushion transforms the goal from a lifelong obsession into a pleasant mental diversion. The subsequent lack of intensity turns you into a major target for committed traders who are still seeking their life's good fortunes.

ANTICIPATION VERSUS REACTION

Most traders wait for confirmation signals before entering new positions, but that's a risky strategy in a modern market environment where whipsaws and fakeouts are the rule of the day. Learning to anticipate price movement lets you take early positions and then use the reactionary crowd to your advantage. Of course, it sounds easier than it is in practice because traders are social creatures looking for other warm bodies before they assume risk. In other words, they don't feel secure in executing their

strategies until the time and sales screen and a fast moving market tell them the coast is clear.

The majority of market players get fixated on the charts or tickers, waiting to see how everyone else reacts at key price points before they're willing to enter the market. However, it's often too late to act by the time they observe the movement or behavior that confirms the breakout or breakdown they want to trade. Well, that's not exactly true. They can enter the market, using a momentum strategy, but that execution style requires a different mindset and reward:risk analysis from the typical swing trade.

Anticipation presents traders with lower risk opportunities than buying a new high or selling a new low. In essence, it means to act without waiting for the actions of other traders. It's a price-based strategy that requires confidence and a strong stomach because it feels like shooting in the dark, especially during the early stages of the new position. It also demands a careful reading of the market landscape to pick out the most advantageous time to assume risk. Anticipation is the preferred execution strategy for the survivalist trader because it responds to specific dangers in our modern markets, like pattern failures and rinse jobs.

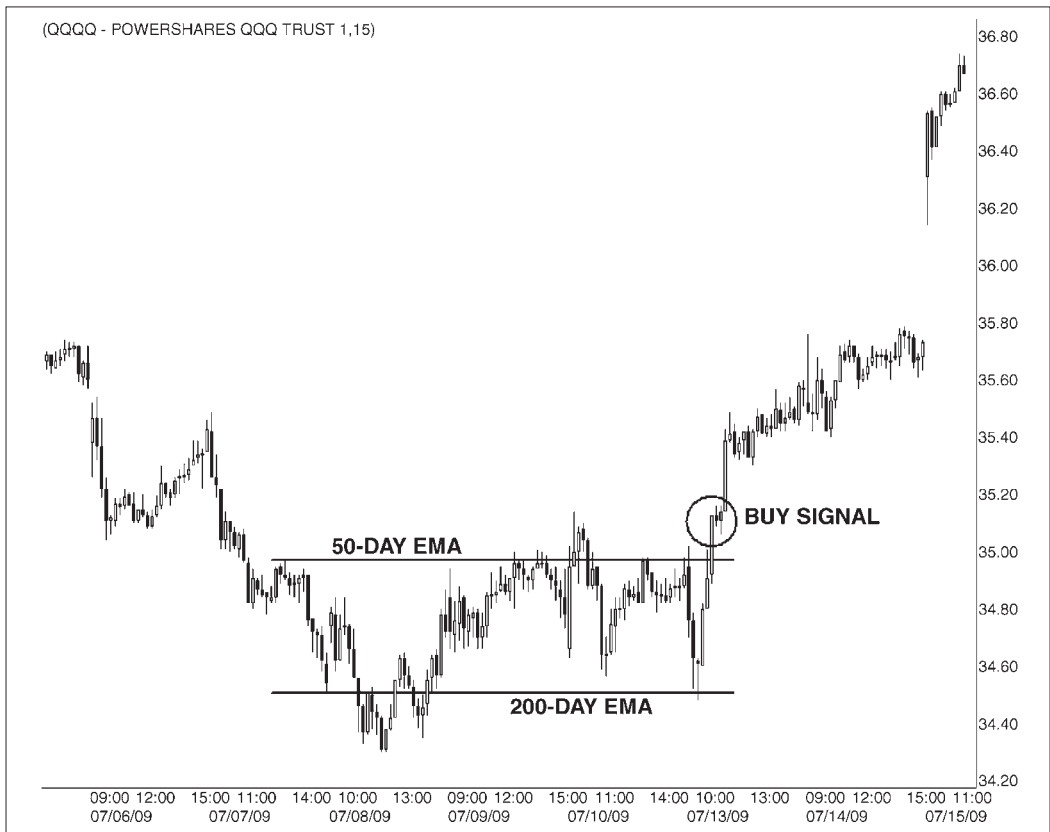
Early trade entry doesn't always make money. In fact, it can trigger more frequent losses than a reactionary market strategy. However, average loss size will be considerably smaller as long as tight stop losses are utilized for new positions. On the flip side, multiple shots can be taken at a promising pattern until the trade finally "sticks" and moves into a substantial profit. This strategy works especially well with patterns that look great but show few obvious entry levels. The trader addresses this ambiguity with a campaign that's willing to take a series of small losses before giving up and moving on to the next opportunity. The biggest variable, i.e., number of losses, is defined by the maximum drawdown for a single position forecast in the broad plan.

Narrow range patterns offer a nearly perfect fit with anticipatory trading strategies. These include triangles and other scenarios in which an active trend goes dead while price action shakes out profit takers and moves into place for the next rally or selloff wave. The coiled spring setup, outlined in Chapter 9 of *The Master Swing Trader*, is a low-risk anticipatory play because you can place a stop loss on the other side of the NR7 bar, with the assumption that a hit stop will signal a larger-scale move against the position. If you're proven wrong and the market whips back in the other direction, you just wait for the next narrow range signal to set up and then reenter the position.

Market dynamics work against reactionary traders because, by the time they're willing to act, the smarter folks who took early positions are already booking profits and heading back to the sidelines. This natural conflict sets up ideal conditions for a reversal into the price level that drew their attention in the first place. This counterswing opens up the pullback trade or pattern failure, depending on the outcome of the test at new support or resistance. This price evolution follows the action-reaction-resolution cycle outlined in the second chapter.

FIGURE 7.1

Strong emotions take control at major conflict levels, generating "rock and a hard place" trade setups. The Nasdaq-100 Trust (previously the Powershares QQQ Trust) sells off through the 50-day EMA in July and comes to rest at the 200-day EMA. It grinds sideways for three sessions, attracting a wave of long and short positions, with both groups equally committed to their points of view. The fund pushes above the two-day high on July 13, trapping short sellers and issuing a strong buy signal ahead of a massive summer rally.



Learn to anticipate trades by focusing narrow attention on the buy-sell swing and looking for clues about which side is winning the latest battle. The biggest trends erupt when one side gets trapped and needs to capitulate. Certain patterns and events, like narrow range bars against the neckline of a broken head and shoulder pattern, can signal entry opportunities well before an actual buy or sell signal. The question to ask is so simple that it's missed by most traders—how would I feel and what would I do if I were long (short) this stock, right here and right now? If the answer is to panic and run for your life, then you know you're onto something special.

A great way to play anticipatory trades is through stocks that are caught between the rock and hard place. Look for patterns that show strong conflict between buyers and sellers and little room for either side to prevail. It's important to act quickly when this scenario sets up because the conflict eventually forces one side to lean too far and get trapped. The capitulation offers ideal dynamics for a breakout or breakdown. In fact, it isn't even necessary to choose price direction in this scenario, just like the bilateral setups outlined in the last chapter. Instead, wait for the battle to play itself out and take a position after one side of the market gains the advantage. Couple this stalking behavior with volatility contraction that supports a stop loss close to the entry price. The combination invariably yields an excellent reward-to-risk profile. Follow the pattern closely whenever you see a trap in the final stages of development and put together a game plan that will get you positioned ahead of the crowd as soon as one side "blinks." This predatory workflow might sound like common sense, but only a handful of traders exercise this systematic approach.

PULLING THE TRIGGER

Does this sound familiar? You stare at the market for days, watching one good trade after another pass you by. You get so frustrated by your inaction that you finally force yourself into a basket of new positions. Like magic, the market turns south at the exact time you get aggressive, forcing you into one loss after another. In total desperation, you head back to the sidelines and the whole cycle starts all over again.

Yes, it's easy to forget that good positions are like commuter trains—if you happen to miss one, another one will be coming down the tracks, right on schedule. Sadly, market players hate the thought of waiting and

wind up throwing themselves onto the empty rails just before the next choo-choo arrives. Clearly, you can't make money when you don't pull the trigger, but you'll lose it even faster if you're too aggressive and trading when there's no opportunity.

How do you overcome this negative loop and learn to pull the trigger at the right time? First, make sure the cards aren't stacked against you. High commissions and slow execution systems can put you into a deep hole as soon as you get filled in a new trade. Simply stated, you don't need to pay more than \$1 per 100 shares, bought or sold, in our modern market. In fact, it makes perfect sense to lower your transaction costs first and find out if your fear in pulling the trigger actually stems from the high cost of doing business. This is especially true with data and news feeds, where you can spend a fortune or nothing at all. Logically, your software investment needs to match your stake size and market risk. For example, it makes no sense to pay \$500 a month for information if you're risking just \$100 in a typical trade.

In most cases, the failure to pull the trigger arises from the fear of losing money. Unfortunately, we get stuck in the mindset that losing is bad, no matter how many times we're told it's just part of the trading game. So one of the first things that a gun-shy trader needs to do is to "get in there" and lose money, enjoying it while it happens. I know, it sounds crazy to enjoy losing money. My point is that traders need to raise their pain tolerance when it comes to taking losses. A great way to accomplish this task is to open a fresh account with a cheap broker and start trading 50 shares at a time. Place a tight stop on each new position, and then walk away. Enter enough trades so that you're in the market 100% of the time. Then sit back and watch how the process unfolds. You'll get stopped out of most positions for tiny losses that won't hurt too badly, but a few will actually make money. Over time, this desensitizing exercise should net out to about even, if you've done the job correctly. No, your bottom line won't change, but watch what happens to your experience level. In a very short time, you've become a bona fide market wizard with hundreds or thousands of trades under your belt.

Realistically, many traders don't have the financial resources to open educational accounts, or they get beat up so badly that even small positions are tough to carry emotionally. So is there any way to regain confidence without risking capital? Try setting goals instead of performance objectives. These can include measures of your ability to predict market movement when you receive fresh data, or how thoroughly you examine the charts each night during your quiet time. Your job in goal setting is to give

yourself a supportive environment that doesn't require real-time performance testing with your own capital. Of course, the underlying goal is to get you back on your feet and into the market with more confidence and the right measure of animal aggression.

8

C H A P T E R

POSITIONS, MARKETS, AND TRADING STYLES

Choosing markets to trade was a relatively easy task 20 years ago. High transaction costs, costly data, and convoluted rules designed to keep public hands off the golden goose led nearly all aspiring traders to open an equity account at Merrill Lynch or a futures account at Lind-Waldock. In both cases, the cost of doing business made trade frequency an impossible luxury and ensured that the brokers would get rich a long time before their clientele.

The Net revolution then came along and changed the face of Wall Street, Chicago, and a few dozen other market venues, opening them up to at-home traders and part-time speculators. Ironically, the results of these dramatic changes have been mixed because it's just as hard to make money trading 500 stocks or futures contracts in a typical year as it was trading just 5 or 50 two decades ago. I guess that's the nature of the market beast, i.e., adapting in Darwinian fashion to systemic changes and closing market inefficiencies as quickly as they're created.

With so many venues in our modern markets, traders need to devote great effort to properly matching their skills, lifestyles, and capitalization levels to market centers that offer the greatest opportunity and the most favorable reward-to-risk profile. This custom fit becomes a definable market edge as experience grows, because the trader will become a master tape reader for his or her markets of specialization. The flip side of this equation is equally important. In the real world, trading too many markets places the trader at an extreme disadvantage to the specialists in the population for that instrument, exchange, or contract.

This is a problem because traders naturally gravitate toward playing too many markets. After all, the grass is always greener on the other side of the hill, which makes the index futures look really good when equity performance is poor, and vice versa. Of course, everyone has flirtations with the forex markets from time to time, even though the specialization required for success in that venue is extremely challenging due to 24-hour liquidity. We're also born multitaskers, believing our skill sets need to work across a variety of instruments because, you know, playing just one market wouldn't use all that wonderful gray matter we have at our disposal.

Newer traders need to experiment with a thousand ideas and markets, exploring what works and what doesn't. But the natural course of evolution dictates that we eventually focus on what makes us the most money. Invariably, this leads to narrow specialization in relatively few types of speculative instruments. It also means leaving behind the entertainment aspect of our trading careers. This poses another challenge because secondary reinforcements, i.e., the adrenaline rush and wish fulfillment, induce us to try new things whenever the old things aren't working out so well.

Traders may choose one market over another because they perceive it to be more or less risky, but, in truth, all markets contain equal risk. Obviously, a tick in the index futures yields a bigger price move than an equal tick in Microsoft or General Electric, but we have full control over the dollar, euro, or yen we're trading through position sizing and stop placement. Price action within each venue is vastly different, although the technical charts follow the same rules of the road. For example, the index futures are notorious for violent swings that occur rarely in blue chip equities. And forex markets are exposed to continual news shocks, with all sorts of foreign ministers in faraway places capable of triggering rapid price change across dozens of currency pairs.

Purely derivative instruments, like options and swaps, are dangerous in the hands of marginal traders but pure gold for intellectual types who understand the impact of volatility on future expectations. Those markets also solve the thorny question of how to profit when an underlying instrument does absolutely nothing of interest to the majority of market players. In fact, the options markets prove the argument that temperament needs to match risk when it comes to speculation.

SUBDIVIDING THE STOCK UNIVERSE

Stock selection needs to follow market phase in order to take advantage of the best opportunities. It must also respond to rotational forces, which affect available buying and selling power. Back in the 1990s, sector rotation evolved over weeks or months. These days, however, it's normal for rotation to occur daily, session after session, for weeks at a time. This constant alternation is a primary feature of the modern market because quant-driven programs change algorithms daily in response to small inefficiencies. There are sound reasons for the survivalist trader to piggyback these programs, buying what they're buying in that session and selling what they're selling.

Traders focusing on the equity markets need to understand the characteristics of diverse market groups and how they react to different events and market phases. For example, semiconductors led the majority of short squeezes during the bear markets that followed the burst tech and credit bubbles. A green-glowing PHLX Semiconductor Index, after a big down opening during those volatile periods, offered a wink and a nod to market players looking for signals to load up on chips and other high short interest stocks. However, the same sector tends to fall asleep at the wheel during beneficial phases in which the major indices are engaged in secular uptrends.

Here's a listing of popular market groups and the spaces they fill within the trading landscape:

- **Dow components.** A great place to look for opportunities during choppy market phases. You can always count on a few Dow stocks bucking the tide and moving higher or lower in well-defined trends. On the flip side, most components show high overlap in

their daily ranges, making them unsuitable for most swing trading strategies.

- **Big tech.** This popular group comprises the highly liquid issues most widely held by mutual funds and the investing public. Group performance is codified in the Nasdaq-100 index and futures contract. Contrary to popular belief, these issues often yield better day trades than swing trades due to channeling behavior that lowers rate of change and exposes stop losses.
- **Biotech.** Subdivide this group into the liquid blue chips and speculative small caps. The small caps make better short-term trading vehicles but show a number of unfavorable characteristics. First, they often hit daily highs or lows at the open, especially in reaction to research data or analyst grading. This makes them high risk for momentum entry. Second, they're highly vulnerable to news shocks, which can trigger devastating losses. Blue chip biotechs tend to trend strongly and for long periods. Like precious metals, these issues move through broad cycles of investor interest and disinterest. At the higher end of the capitalization scale, they act more like drug stocks, which are affected by regulatory mechanisms that hamper growth potential.
- **Story stocks.** Wall Street loves a good story because it helps to sell stock to the public. Every market environment, good or bad, yields a handful of issues that trend more sharply than the major indices because the company possesses a trait, product, or advantage that is easily understood by the marginal investor. Most times, these stories wither up and die over time, but occasionally they'll yield the next Microsoft, Starbucks, or First Solar.
- **Metals.** Precious metals trade in long cycles that tend to overshoot natural support and resistance levels. Many of the underlying equities are held back, in both directions, by hedging practices that reduce their exposure to short-term futures movement. Industrial metals are proxies for economy growth and contraction worldwide. In recent years, they've taken on the role of the canary in the coal mine for notable shifts in the economic cycle.
- **Energy.** This sector was a sleeping giant for decades. It woke up with a vengeance at the start of the 2003 equity bull market and will remain a major play for the next generation due to climate change issues. Oil and oil services stocks tend to move with the underlying commodities during quiet periods and with the broad indices during volatile periods. Like industrial metals, these stocks are proxies for worldwide economic demand.

- **Transportation.** These issues may trade in reverse lockstep with the energy markets due to hedging plays. This is especially true with the airline stocks, because profitability is closely tied to fuel costs. Trucking, shipping, and railroad issues react to economic shifts and make outstanding plays during the strongest and weakest phases of the cycle.
- **Cyclicals.** Building equipment, paper companies, and chemical manufacturers all share the cyclical label, which yields the strongest performance in the early stages of a new economic cycle and the weakest when growth tops out and starts to contract. Cyclicals respond well to falling interest rates, which loosen up credit availability and stimulate growth.
- **Financials.** The sector goes through long phases of quiet boredom, with mild trends and few opportunities, followed by equally long periods of rapid growth or compression. Crisis periods are the exception rather than the rule, despite two historic blowups in the last 20 years. These stocks tend to trend more sharply near high and low economic turning points.
- **Retail and restaurants.** Mall anchors, discount clothiers, and specialty eateries act as proxies for the consuming public. Open wallets and free-flowing credit trigger strong uptrends, while retrenchment and employment anxiety yield equally strong downtrends. These sectors are also great places to find story stocks attracting speculative capital.
- **The generals.** There are always a handful of stocks that characterize an entire bull or bear market, like Apple in the 2003 to 2007 uptrend, or Citigroup in the vicious bear market that followed. The issues are beloved or hated by Wall Street, triggering strong trends followed by violent retracements. Timing is everything with the generals, which make good longs when they're beaten into the ground and equally good short sales when they're universally adored.

Liquidity, as calculated by a 60-day average daily volume, is a major consideration in choosing your favored plays of the day or week. The bottom line: it's best to avoid all stocks that trade less than 200,000 shares per day, on average. This is especially true in volatile markets because these issues can swing through wide ranges with an illiquid bid-ask spread that will hurt badly if a fast exit is required. There's just no way to manage risk in this scenario, which makes them unsuitable for the survivalist trader. Alternatively, there's a sweet spot in the small cap universe,

between 200,000 and 500,000 shares, which yields a plethora of well-defined trends and manageable price movement. This narrow liquidity zone often captures the momentum plays being hawked on stock boards and in chat rooms. Many of these issues can yield outstanding gains over short periods, when entries are well timed. You can find these winners simply by pulling up a list of Russell 2000 Index components and sorting by average daily volume, with a secondary sort by relative strength, using the Price versus 200-day MA formula outlined in Chapter 4.

Price is as important as liquidity in choosing winning trades. Single-digit stocks, in particular, represent a unique subset of the market universe. These issues generally fall along two common threads. First are the battered stocks that have fallen from grace due to weak earnings, an out of favor sector, or a bear market environment. These broken issues can drop under 10 bucks and stay there for years at a time, until the cycle finally reverses. The trick in finding good plays within this subgroup is to back up and use the weekly charts to locate major turning points, such as the completion of a long basing pattern.

The second single-digit thread generally offers better trading opportunities. These are the small stocks, often coming off the pink sheets and onto national market listings because their capitalization levels are growing. This group also includes junior biotechs that have interesting drugs in the pipeline or sugar daddy partners that are funding their research. All of these issues can produce outstanding profits under the right circumstances. Sadly though, single-digit stocks can trigger devastating losses as well. Low-priced stocks move through higher daily percentages than more expensive ones. That won't matter if positions are sized properly, but that's less likely to happen with cheap stocks because it's easy to get fooled by total exposure, which tends to be small compared to big tech or blue chip positions. In addition, undercapitalized traders are attracted to these issues because they fit into their small size accounts, with less risk of a margin call. This is a double-edged sword because, on the one hand, we're smarter than these folks and can often find ways to profit from their mistakes, but on the other hand, these stocks will go absolutely crazy when these folks panic and try to get out.

Single-digit stocks work best in a basket that includes a good measure of their higher-priced brethren. In this way, we can give them the running room they need to generate a decent profit. As a general rule, take the size you'd really like to trade in these issues and cut it by a quarter or a half, and then enter the market. This added caution will keep you in the trade longer, and in a better position to catch the next big rally or selloff in your favor.

EXCHANGE-TRADED FUNDS

Exchange-traded funds (ETFs) draw intense trader interest for the same reason that index futures have become so popular in recent years—it's completely logical to avoid individual equity exposure and head straight into the mother lode of index and sector movement. But ETFs suck in a huge amount of capital that never translates into profits because a majority of market players forfeit their edge when they decide to play these highly liquid instruments.

Consider the methodology we use to buy or sell stocks or other trading vehicles we've deconstructed during our careers. The chart sets up a pretty pattern, with favorable reward:risk. The expected price swing falls into our time frame of interest and requires a capital commitment that's consistent with our trading plans. Finally, the broad market supports our intended strategy and raises the odds that our risk taking will yield a profit. In total, this workflow defines the trading edge we're using to take money out of the market.

Then consider how most traders play exchange-traded funds. A macro story or short-term theme emerges, like strong gold or weak tech. We look for a way to take advantage of the well-publicized trend but find no particular vehicle of interest. So, instead of waiting for the low-hanging fruit to set up, we throw money impatiently at related funds because they're so damned convenient. Unconsciously, and in conflict with our discipline, we believe the instrument should capture the emerging trend because, after all, that's why it exists.

In the process, however, we've thrown our risk management out the door and made the same mistake as a reactionary crowd that doesn't know the difference between a price chart and an earnings report. In reality, there's just one valid reason to assume risk in any financial instrument, i.e., our trading edge will take advantage of its location, direction, and momentum. In other words, it's a mistake to trade any exchange-traded fund until it yields a valid buy or sell signal. This sounds like common sense, but it isn't, considering our tendency to overtrade in the least favorable environments. In a way, these popular funds are like Eve's apple, tempting us with opportunity when there is none. There's a simple solution to this conflict: apply the same discipline to ETF trading as any other financial instrument. This means engaging in stalking behavior over long periods and waiting for the patterns to set up properly. Of course, this is easier said than done in a dull environment when you can't find good trades in your preferred vehicles. But, like everything else in the markets, it can be done successfully.

The survivalist trader should first establish a consistent track record buying or selling normal equities and then extend risk exposure into the more volatile stock derivatives, like exchange-traded funds and options. Sadly, many folks do the exact opposite because they're blinded by greed. In truth, the rock solid discipline gained through profitable equity trading becomes the foundation for success in the more cutthroat derivative markets.

The most popular index funds provide a convenient alternative to the index futures, with far less leveraging. A few hundred shares of the SPDR Trust (SPY) or Nasdaq-100 Trust (QQQQ) can take advantage of an emerging trend, with limited risk and excellent survivability during adverse movement. Commodity sectors are especially well suited to ETF plays, with useful proxies for gold, silver, and agricultural products. But not all commodity funds are created equally as traders discovered when crude oil plunged in the summer of 2008. The U.S. Oil Fund, an extremely popular instrument during crude oil's parabolic rally in 2007 and early 2008, failed to bounce at the same percentage as underlying commodities because of the way it handled spot versus future pricing, a.k.a. contango. Traders playing the fund got burned badly at that time, finally abandoning the instrument for newer vehicles that tracked futures pricing more faithfully.

Longer-term moving averages work extremely well with sector-based ETFs because institutions execute broad strategies that utilize these price levels. For this reason, it's a great idea to keep 50- and 200-day EMAs on all ETF charts and to look for reversals when these levels come into play. It's best to avoid highly synthetic instruments, like superleveraged funds, unless you're sitting at a professional trading desk. These ETFs attract two primary crowds, well-oiled hedge funds and undercapitalized traders mesmerized by the rapid price movement. This conflict sets up ideal conditions for chronic trapping behavior in which gaps and intraday rinse jobs routinely take out common support and resistance levels. It may not be obvious from the daily charts, but the tail wags the dog with these highly volatile instruments. Simply stated, manipulation of superleveraged funds, especially in the final hour of trading, can reverse or accelerate trends in the underlying sectors or indices. This is contrary to the intended purpose of derivative instruments. Also, consider that high leverage built into these instruments takes that strategic decision out of our hands. This isn't a huge problem when we reduce position size and tighten up stop losses, but the opposite happens with the marginal trader.

There's also a broad misconception that these funds move in lockstep with the underlying sector or index over long periods of time. This just isn't true because the instruments are aligned with daily price movement, not weekly or monthly trending. In addition, they carry higher than normal expense ratios, which feed back directly into price development.

POSITION CHOICE

Equity positions that match the current market phase have the highest odds of profiting from the tradable pattern. Location of the major indices (or index futures) establishes the current phase through stage analysis. For example, the S&P 500 selling off, after breaking a topping pattern, denotes a downtrend phase that will respond well to short sales. The scenario also favors pullback plays if the downtrend is occurring within the context of a larger scale uptrend. Chapter 3 of *The Master Swing Trader* outlined the progression of these stages and their related opportunities through lows, bottoms, breakouts, uptrends, tops, breakdowns, and downtrends. Clearly, the devil is in the details when looking for the most advantageous position choices of the current phase. The biggest roadblock comes from false identification, in which you believe you're trading one cycle segment when, in fact, another is actually in play. This trend relativity error is exasperated by the three-dimensional nature of trends, which explains why the pullbacks in a falling market can be so rewarding and so dangerous, all at the same time.

As I noted in Chapter 6, context is everything in the financial markets. A proper reading of the cyclical elements, as well as their hierarchical positions within the current phase, is absolutely essential in picking out the most profitable play for that market in that particular session. Logically speaking, this is easier to accomplish than it sounds because trending flows from longer into short time frames. In other words, a weekly trend is more resilient than a daily trend, which, in turn, is more resilient than a 60-minute trend. With this in mind, we should always assume that a daily selloff will bounce at weekly support, while a 60-minute uptrend will fail at daily resistance.

The relative placement of current price between active trends generates the vast majority of swing trading strategies. Realistically, when we have a database filled with promising patterns, just a few will:

- Show the right combination of relative trends.
- Match or converge with the current market phase.
- Trade at or near a targeted entry price.

In many cases, the equities we finally choose for exposure will be grinding through similar patterns as the index futures, but every market phase supports diverse strategies and relative trend combinations. The primary question to ask when you're staring at a promising pattern is simple enough: will it work for this market on this day?

Position choice must also respond to the unique attributes of the trading plan, which has predefined risk tolerance, holding period, and profit objectives. That document, whether mental or physical, will rule out otherwise good-looking opportunities that don't match these primary filters. Of course, you can change the plan at any time, but doing so just before the opening bell, because you'd hate to miss out on a big rally, is a terrible way to run a trading business.

Not all sectors move in lockstep with the major indices. For example, precious metals often go against the grain, rising on down days and falling on up days. Small biotech and other speculative plays will ignore the broad market direction completely and react to research news, upgrades, euphoria, and even chat room hype. And, as I noted earlier, energy stocks sometimes trade with the markets and sometimes trade with the commodity futures. Countermarket plays, whatever their source, let traders uncover good positions in dull or dangerous sessions that don't offer easy entry into the usual suspects.

FINDING MORNING MAVERICKS

1. Look for green on the screen after a big down opening. Stocks that don't respond to early selling pressure may stay resilient for the entire session.
2. Pull up an index component list, and look for the leaders in a down market and laggards in an up market. This method works especially well on the Dow Industrials because of massive daily rotation by index players.
3. Sort a list of 40 sectors and exchange-traded funds after the first hour, and see which are bucking the tide in that session.

4. Make a list of tier one broker upgrades on a down day or downgrades on an up day. These issues often attract a ton of contrary capital.
5. Find out which sectors were unusually strong or weak in the Asian and European sessions. Then focus your attention on similar groups trading against the morning tide.

Correlation between intraday leadership adds another layer of actionable data because it generates convergence-divergence relationships. For example, positive performance in a number of consumer-oriented sectors, like retailers, restaurants, and hotels, exposes institutional bets on economic growth three to six months down the road. And a mixed session in which oil services are higher while coal and natural gas are lower points to narrow interest in the production side of the energy spectrum, as opposed to a broad interest in the raw materials sector.

Any combination of sector indices and liquid exchange-traded funds can be utilized to create your daily sector watch list. Stick with the most popular corners of the market, and don't try to include every small segment of price activity. Expect relative performance to shift quickly during the first hour, when everyone is looking for what's working and what's not in that particular session. The list should stop jumping around after the first 90 minutes and settle into obvious categories of buying and selling pressure. Check open positions at that time, and see whether they align or misalign with the daily rotation. Major adjustments might be needed, especially if you're positioned in trend plays that are being targeted for intraday pain.

Watch the patterns of sector rotation between sessions. Hedge funds execute all sorts of mean reversion strategies that utilize standard deviation measurements in short-term price movement. These are massive plays that spread long and short positions into hundreds of instruments across multiple markets. For example, these folks will play a basket of commodity sectors on the long side, pushing prices as far as they can stretch in a single session. Then they'll turn around and sell short the same sectors in the following session, until they hit a median line that points to the normalized prices for those instruments. Visually, this is akin to pushing price up and through a Bollinger Band, reversing, and then dropping back down to the basis line.

Tracking multiple sector performance over days or weeks will reveal these complex strategies, which can then be piggybacked or utilized as a filtering mechanism for your cycle-aligned positions. If you haven't figured it out yet, this tape reading technique gives the survivalist trader a powerful tool for coexisting with program algorithms that have become the 400-pound gorillas of the financial markets in recent years. This is especially useful when volatility and volume are tracking higher, in unison, because it points to heightened institutional participation.

Watch for changing patterns in weekly rotational activity as well. These subtle shifts can expose emerging trends well before the underlying charts hit breakout or breakdown levels. To start, look for alignment between sectors that are leading or lagging the intraday list three to four times a week. Then pull up a long-term relative strength indicator, like the smoothed 14-day Wilder's RSI, and see if those targeted groups are shifting direction from an overbought or oversold level. With a little effort, you can uncover these secular shifts early in the rotational process and utilize the knowledge as a trading edge, entering the market before the reactionary crowd starts to pile in on the long side or pile out on the short side.

A well-maintained sector list also signals the arrival of trend days, which are great times when you're on the right side of the market and total disasters when you're positioned incorrectly. Trend days mark one-sided sessions that go directional right after the opening bell and continue in that direction right up to the closing bell. Traders can expect just two or three trend days in a typical month. Sector lists show lopsided behavior early on trend days, with nearly all categories flashing green during rallies and red during selloffs. The few exceptions may be in the countermarkets, like gold and bonds during a big selloff day.

Watch real-time up-down volume indicators in the main exchanges to confirm the onset of a trend day. Look for a lopsided tape in which 80% or more of total volume comes in on the buy side during a rally and sell side during a selloff. These extremes should be matched by lopsided market breadth, which exceeds plus or minus 1,800 to 2,000 on the NYSE and Nasdaq exchanges. While 80:20 days can occur regularly, the 90:10 volume day holds a special place in market lore. Traditionally, this asymmetrical event pointed to a major turning point in long-term cycles, like a secular bull or bear market. However, the explosion of program trading has changed all that, with as many as a dozen 90:10 days now popping up during the course of a typical trading year. The all-too-frequent occurrence illustrates the overriding dominance of lockstep price behavior, driven by

automated strategies and the legion of piggybackers following the gargantuan hedge funds.

SIZING, SCALING, AND EXPOSURE

The number of trades you take simultaneously, and their relative dollar value, has as much to do with organizational ability and skill level as pure capitalization. The challenge for the well-capitalized survivalist trader is simple—can you track and manage all of your open positions at the same time, or do you get overwhelmed? Diversification is also important when you carry multiple positions. For example, if you buy five chip stocks and the sector rolls over, you're now stuck with five losing positions. So the trading basket, whatever its total dollar value, needs to mix it up with diversification or, in reality, you've just taken one big position that can go bad in a hurry.

Few trading issues generate as much confusion as position sizing and scaling. We see a great-looking pattern and want desperately to get on board, so instead of planning a strategy that manages risk, we just throw money at the trade and hope for the best. A far better plan is to take a deep breath and consider the three size and scale variables that will impact reward:risk:

- How many total shares to trade
- Whether to take risk all at once, or in pieces
- Whether to unwind risk all at once, or in pieces

Transaction costs also impact position sizing and scaling. Does your broker charge per ticket, or per unit share? Unit share fees let you pay for what you buy, rather than a flat price for each entry or exit. How large or small is your trading account? Small accounts have little choice but to execute trades in single blocks, because ticket fees will add up quickly. On the flip side, large accounts can execute all kinds of scaling strategies and still not break the bank. As an added benefit, large positions in large accounts overcome ticket pricing because the fees represent a negligible chunk of the total trade cost.

Time management and position scaling go hand in hand. When you have the luxury of time, use it to build positions at the most advantageous prices. For example, you want to own Applied Materials for a two- or

three-week trade at an average price of 23. You can buy pieces of the stock all over the vicinity of your intended average and use intraday volatility to seek fills that lower the price even further. The same strategy applies to trade exits. Let's say your position is moving higher, and you want to take pieces off the table in order to lock in profits. Once again, you apply time management to take advantage of natural market fluctuations. You sell part of the position into a morning rally, another piece into a topping formation, and a final unit into an afternoon buying spike.

Traders overlook the importance of sizing in managing risk. There's a huge difference between trading 1,000 shares of a sleepy soap company and 1,000 shares of a chat room rocket. Unfortunately, many of us will play both types of market vehicles in exactly the same manner, although the two risk profiles are completely different. Simply stated, it's a good idea to reduce position size when trading small caps or other highly volatile stocks because this containment will keep you from getting stopped out during routine intraday oscillations. Conversely, trade larger size with slower-moving stocks, and draw out your holding period. You're less likely to get stopped out due to lower volatility and will also improve opportunity-cost by giving the position more time to move away from your entry.

At what point should you think seriously about increasing average share size across all instruments? Ironically, it's a two-edged sword because, as you trade larger size, you'll get more gun-shy, which will make it even harder to stick to your trading plan. For this reason, it's best to move slowly and develop a set of workflows for growing your risk and monitoring its impact on day-to-day performance. Since the value of a price swing is greater when you carry a larger position, average profit and loss size will increase as well. So, if you find that overall profitability doesn't rise in proportion with your increased risk, reverse gears and go back to small lots for a few more weeks or months.

Finally, overcome a common mistake and ignore margin completely when computing total size. Many traders believe they need to buy or sell as many shares as their margin accounts will allow. But each opportunity carries an optimum position size that exists independently of the account size. This elusive figure is a combination of risk, volatility, and the odds the trade will work out in your favor. To figure out each element of this jigsaw puzzle, apply the swing analysis workflow outlined in Part Three to measure your reward:risk at each point of entry. Then role-play different sizing scenarios and the potential dollar impact if things should go to hell.

Averaging down and up attracts its fair share of detractors because the strategy goes against the market wisdom that we should never add to a losing position or turn a winner into a loser. Despite this admonition, dollar cost averaging works extremely well with certain trading strategies. However, it's a highly selective process requiring strong discipline because the entry method is a ticket to disaster when applied for the wrong reasons. For example, adding to a losing position can end your career if you're doing it in desperation, trying to work your way out of a black hole.

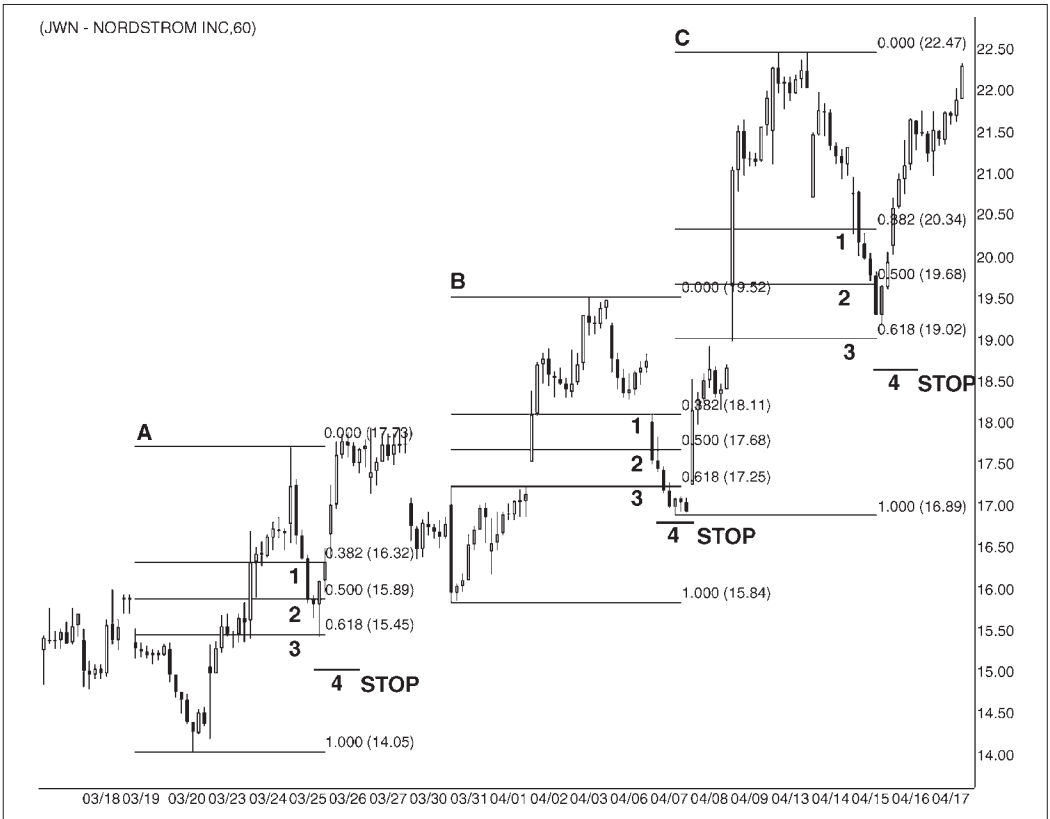
Swing traders are market opportunists who don't buy or sell for the long haul. Our small window of opportunity forces us to predict what the market is going to do over very short time frames. For this reason, most averaging techniques work best in congested markets and trading ranges, where price swings reflect high noise levels rather than the onset of a trend higher or lower. However, the well-managed pullback play is a major exception to this rule. These classic opportunities make it tough to find perfect entry prices, but they do allow us to work into profitable positions by taking smaller pieces of the trade as price moves against us. Of course, this is better known as "buying the dip."

In Figure 8.1, Nordstrom rallies off the March low, setting up a series of pullback trades. One effective entry strategy is to weigh shares toward the lower end of support, keeping the average price well under the midpoint of three partial positions taken at equal distances. For example, you want to buy 1,200 shares of Nordstrom as it pulls back following a strong rally wave. Put up a Fibonacci grid, buying 300 shares at the 38% retracement, 300 shares at the 50% retracement, and 600 shares at the 62% retracement. This tiered approach yields an average price under the 50% retracement. In trade A, partial buys at 16.32, 15.89, and 15.45 yield an average cost of 15.77, or just 32 cents above the final entry price. Enter the stop loss immediately after buying the third position, placing it around the 70% level to avoid whipsaws but taking you out of the trade if the stock falls into the 78% retracement. You'll recall from an earlier discussion how a selloff into that level can set up a failure of a failure buy signal when price rallies back above the 62% retracement. Getting out and waiting for that trade to set up is a better option than holding onto the loser and praying for a reversal.

The three trades (A, B, C) show that this strategy can go wrong in many ways but still yield decent profits. For starters, trade A hits the 62% retracement perfectly, trade B overshoots it, and trade C never reaches it.

FIGURE 8.1

Three Nordstrom trades.



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So the final results vary, depending on the level where the falling stock finally bounces:

- **Trade A:** We get 1,200 shares and a strong bounce, letting us take profits at the swing inception point at 17.73.
- **Trade B:** We get 1,200 shares but might get taken out for a 75- to 80-cent loss if the stop is placed too close to the final entry. Or the position barely survives and surges into a healthy profit the next day.
- **Trade C:** We get just 600 shares, with an average entry price at 20.01 $([20.34+19.68]/2)$, but that position moves into a profit quickly.

The pullback dynamics tell us we may never get all the shares we originally planned to trade. But that's a good thing because it also means the market has turned in our favor, ahead of expectations. In essence, this averaging strategy gets us a smaller piece of a profitable trade rather than a whole measure of an unprofitable one. But what happens if the stock, futures contract, or currency keeps selling off and drops through our lowest entry? Well, in truth, averaging down or up works only when we apply tight stop loss criteria.

In addition, the reward target must be great enough to justify the increased risk of taking entries at lower and lower prices. It's simple enough to calculate this important equation using swing analysis. Compute your average entry price if all your shares get filled. The distance from this number up to the next resistance level (profit target/reward) should be at least three times the distance down to your stop loss (failure target/risk). Simply stated, if these numbers don't work out in your favor, don't average into the position.

Many times you don't have obvious charting features, like Fibonacci retracements, to localize your dip entries. This is especially true with pullbacks after parabolic rallies or selloffs, in which the counter-trends are unlikely to reach the 38% retracement. If reward:risk "looks" favorable, find small ledge or consolidation patterns within the parabolic rally, and place orders at those levels that add up, in total, to just half your normal exposure, with a tight stop loss just under (or above with a short sale) the final entry. Your last entry needs to scrape up against whatever support level you can find. If the stop gets hit, reboot the setup and look for new entries, risking the other half of your normal position size. If this trade fails, it's time to cry uncle and move on to a new opportunity.

It should be clear by now that we're talking about dollar cost averaging in a pullback strategy, rather than ignoring your discipline and trying to trade out of a loser. What's the key difference between these two strategies? In dollar cost averaging, we follow our original plan and pre-chosen escape route. In its evil twin, our plan has already failed and we have no escape route. Just make sure you know which strategy you're actually applying before you hit the enter button.

Let's summarize what we've learned about position sizing and scaling:

1. Ignore margin when computing position size. Each opportunity carries an optimum size that's independent of the account size. Find it and trade it.

2. Think small if you have a small account. Take smaller positions and increase your holding period to weeks or months, rather than minutes or hours.
3. Trade like a winner but think like a loser. Visualize the worst-case scenario for the size you want to trade and never exceed your plan.
4. Take big positions for short time periods and small positions for long time periods. Courage is inversely proportional to position size.
5. Use time to your advantage. Spend hours or days building positions at the most advantageous prices.
6. Compute your transaction costs in advance. Change brokers if you're trading small and paying flat-rate fees, or trading large and paying per-share fees.
7. Scale slowly into pullbacks and quickly into congestion. Even a small piece can yield a big profit when a pullback bounces ahead of expectations.
8. Align size with the risk profile of the market you're trading. Drop down to a smaller position when trading a volatile stock.
9. Trade bigger with slow-movers and then get out of the way. You're less likely to get stopped out.
10. Move slowly when increasing position size, and take a giant step back if results don't support the added risk.

BASKETS

Why trade just a handful of stocks when you can play 20 or more and never skip a beat? In fact, it's possible to manage dozens of equities simultaneously in a way that reduces overall risk to your trading account. Here's how it works. Institutions and funds use basket trading to focus capital on targeted movement or to spread risk across many instruments. These baskets might look like investment portfolios, but they're actually trading vehicles. In other words, they need to pay off over shorter time periods. But isn't it easier to just buy or sell liquid exchange-traded funds? No, in fact it's harder to make money because ETFs force you to play all the components rather than cherry-picking the issues you expect to outperform on the upside or underperform on the downside.

Professionals create baskets through a variety of techniques. Many sophisticated strategies apply rules-based analysis, better known as algorithms, to capture opportunities through extensive back testing. These methods identify groupings of stocks and other instruments that capitalize on market inefficiencies with a high degree of correlation. Of course, many things can go wrong with this approach. For example, fund managers often ruin perfectly good baskets by over-tweaking the many components or trading signals. A bigger problem comes from the historical data. At any given time, the performance of a specific market phenomenon can deviate greatly from its long-term mean. We saw this happen in the summer of 2007 when quant funds got decimated because they forgot to calculate the impact of volatility into their performance projections.

Sector and index tracking offer the most convenient venues for traders to integrate custom baskets into their own strategies. These homegrown techniques will often outperform their larger cousins due to our intimate knowledge of specific equities and market groups. It's a simple process as long as your broker supports unit or per-share pricing. Most direct access brokers now charge by the share instead of a flat rate, like \$9.95 per trade. A typical fee schedule may cost one-half cent per share with a one-dollar minimum per order, which translates into five bucks per thousand shares. More advanced brokers also support entry methods that gather the entire basket into a single file that can be bought or sold with a single mouse click.

Putting together a well-correlated basket requires a good deal of legwork, but it isn't that hard to accomplish. First, sort a group of index or sector components into a relative strength list. Do this by examining price change over a specified period or the percentage distance above or below the 200-day moving average. Drop down to a shorter-term moving average for baskets that contemplate shorter-term holding periods, keeping in mind that the strategy is too labor-intensive to work as a day trade or for an overnight flip. Then, build your basket to (a) favor the strongest or weakest stocks, or (b) create a spread strategy that favors subgroups within the sector or index. For example, you can compile an interesting semiconductor spread by buying the equipment companies and selling short the fabricators, or vice versa. This bilateral approach has an added benefit: it reduces the influence of lockstep behavior when macro forces are moving the sector or broad market.

How many shares of each stock should you buy or sell short? Equal weighting works best when you're trying to outperform a sector or index

with a basic directional strategy. Keep it simple. Pick up an equal number of shares when they're priced close to each other. Double or triple the shares when the stock trades at a much lower price than the rest of the basket. Just make sure the entire value of the basket doesn't expose your account to more risk than you're willing to take.

THREE WAYS TO MANAGE BASKET RISK

- Pull up a related sector/index chart using breakouts and breakdowns on those patterns to make buy and sell decisions for the entire basket.
- Create a single chart of the combined components using a technical analysis program, and use that pattern to make buy and sell decisions.
- Apply a flat dollar or percentage stop loss to the entire group.

Say you want to build a basket of Dow Industrial components. Of course, you can buy the entire index through the Dow Diamonds Trust ETF or the Dow futures, but in a directional strategy, you'll do better removing the weakest components and then creating a basket with the remaining issues. A simple filtering process utilizes a subgroup of issues that are at least 10% above the 200-day EMA. Once you've settled on the components and size of each position, wait for the Dow chart to trigger an entry signal through a typical breakout, narrow range, or pullback pattern. You're free to exclude any issues you don't want in the basket, but don't make individual changes after the stocks have been bought or sold short. In other words, it's absolutely vital that the entire basket be traded as a single instrument in order to maintain its risk characteristics.

This hands-off approach requires considerable discipline and a strong stomach. In the real world, a few basket components will go the wrong way while another subgroup does absolutely nothing. Keep in mind that you're trying to profit from the average performance of the basket, with your edge defined by the filtering process rather than subsequent price movement. How do you know if your basket is working or failing? That's easy. Just compare its performance over time to the underlying sector or index. In a nutshell, there's really no point in basket trading if you're not beating those numbers by a wide margin.

SURVIVALIST HOLDING PERIODS

How long should you hold onto swing trading positions? That decision depends on your lifestyle, capitalization level, and how much time you can devote to the financial markets. It's easy to trade in and out of positions by the hour if you're watching every tick, but folks with real lives away from the markets need to hold positions longer and use passive management tools, like mechanical stop losses, to protect themselves from catastrophic losses. Don't let a holding period be a noose around your neck, but it's important to understand that the market is a giant chessboard on which opportunities in one time frame are matched with ugly traps in another time frame. Here's an example that's hardwired into every trader's DNA. You buy a strong stock around the noon hour. It responds immediately and lifts the position into a substantial profit. The issue shows no signs of weakness as it heads into the closing bell, so you hold it overnight with the intention of taking profits at the next day's open. However, the index futures are flashing bright red when you awake, and your stock gaps down, instantly transforming that pleasant profit into a depressing loss.

The stock in this example generates a great opportunity in the intraday market but a nasty bull trap as an overnight swing trade. To complicate matters, the uptrend can easily recover after the gap shakes you out of the trade and even run to new highs by the close of that session. However, you have no choice but to deal with the infinite variables in real time and pick the best strategy for your risk exposure in that particular environment. No matter how you cut it, the most logical decision is going to be dead wrong a good percentage of the time.

Simply stated, it's best to adjust your holding period to the specific opportunity being offered at the time. Admittedly, this advice conflicts with my point of view in *The Master Swing Trader*, which recommends that traders pick a single holding period and learn to play it well before moving on to another. This strategic shift comes in adaptation to a survivalist trading mentality. Program algorithms set innumerable traps through different time frames, depending on the changing flow of market behavior. The survivalist trader responds best to this unpleasant reality by stepping out of the way as soon as the trap is recognized. Which brings us back to the profit-lost-to-the-gap scenario. In the 1990s, a strong close triggered a generally reliable signal for even higher prices in the next session. Funds have deconstructed this well-known bias in the last decade, making follow-through strategies a total crapshoot except in very strong trends.

Even then, opening traps become commonplace as soon as one side of the market gets too aggressive.

The three-dimensional trend puzzle is especially difficult for novice traders to translate into working strategies. As a result, these folks should continue to play single holding periods and step back to the sidelines whenever trapping behavior starts to undermine their results. This discipline requires the addition of a filtering mechanism that responds to weakening profit and loss patterns while avoiding the mental juggling act that comes from turning a day trade into an overnight position and vice versa.

You're probably thinking it's impossible to figure out which market players and holding periods are getting targeted at any point in time, but nothing could be further from the truth. Start by asking this question: who are the weakest hands in the market right at this minute? The answer is often obvious because it aligns with the strategy and time frame that requires the least effort, i.e., the lazy trade. In a nutshell, the lazy trade will *always* get punished. Still not clear on this simple point? Then head over to the mirror, and look at the guy or gal staring at you from the other side. We've all been lazy traders from time to time and understand, instinctively, the gut pull we feel during every twist and turn in the price action. Giving in to that stomach-churning instinct invariably triggers the lazy trade and an eventual smack across the face.

The best way to manage multiple holding periods is to keep separate accounts for intraday, overnight, and multiweek positions. This isn't always practical because the resources of most retail traders are limited. Retirement accounts generally work better with longer-term holding periods due to the cash settlement limitations. The separation between accounts comes in handy when positions move against you because longer-term holding periods yield different reward:risk profiles and looser stops than shorter-term holding periods. That said, at times even the longest holding periods can get trapped just as viciously as overnight plays. Just ask the American public, which lost nearly \$40 trillion in family and retirement accounts during the 2008 crash.

While it makes sense to utilize multiple accounts to handle different time frames, it isn't always possible. Many times, we've established positions with the intention of holding on for multiple days, but intraday price action alerts us to the likelihood of a trap if we stick around too long. This early warning signal requires on-the-fly holding period adjustment to account for the rising danger. Admittedly, this is more art than science because it depends on incomplete observations that might change by the

closing bell. The best path in this scenario is to reduce position size and lock in some profits. A smaller position, by itself, might address the perceived danger of adverse movement. At a minimum, money lost on the smaller trade can be averaged with the real savings of pulling a piece off the table at the right time.

While it's important to understand human behavior when computing the likelihood of an overnight trap, basic technical tools also do a decent job. Reversals and shakeouts tend to occur at major conflict levels on the charting landscape. Emotional bias becomes the main obstacle in recognizing these inflection points because we tend to ignore contrary technical signals when caught up in price action that's favorable to our positions. In fact, if you look back at the many times you've turned a winner into a loser by holding it overnight, you'll discover the traps were often identifiable through convergence-divergence signals, i.e., the location of advancing or retreating price in relationship to various support and resistance levels.

Large-scale pattern features, like the 200-day moving average or a multiyear high/low, require special holding period considerations. Markets can test these long-term price levels for weeks before giving way to a breakout, breakdown, or reversal. In the interim, the back and forth swings test the emotions of traders that see every uptick as a breakout or every downtick as a breakdown. The proper response to this testing process is to shorten the holding period considerably and to keep things on a tight leash until the market finally shows its hand. Indeed, marginal players get into huge trouble at these levels because they lack the discipline to follow this simple admonition and to take profits aggressively rather than wait for the phantom trade of the century.

For example, a falling stock pulls back into 200-day moving average support. We know there's a good bounce trade setting up, but it probably won't reward longer-term entries until downside momentum finally washes out of the system. That reversal process could take days or weeks because this level points to a conflict *zone* rather than a narrow line in the sand. With this in mind, a shorter-term holding period makes sense, taking opportunistic profits on buying spikes and heading back to the sidelines until a basing pattern finally sets up and supports the long-term bull pattern that caught our attention in the first place.

Finally, scale down this two-pronged approach to smaller charting landscape features, like the 50-day moving average or a horizontal Bollinger Band. Opportunistic hand-to-mouth strategies and holding periods are just as important because these levels also signal conflict that favors trapping behavior, at least for a few bars. As with the longer-term scenario,

we tighten the holding period until a reversal pattern (on the 60-minute chart, in this case), sets up to support the bigger play.

REMOTE TRADING

Modern markets support a variety of time-based strategies. At one end of the spectrum, the fast-fingered crowd throws money at price swings that come and go in minutes. At the other end, old-timers toss stock certificates into boxes and forget about them for decades. Most of us feel comfortable playing in the broad middle ground between these two extremes. In other words, we don't jump on every wiggle or waggle, but we still respect the virtues of market timing. A few of us have the opportunity to watch the ticker tape in real time, waiting for perfect trades to set up, but the vast majority have real lives away from the markets and need to apply time-based strategies that match their busy lifestyles.

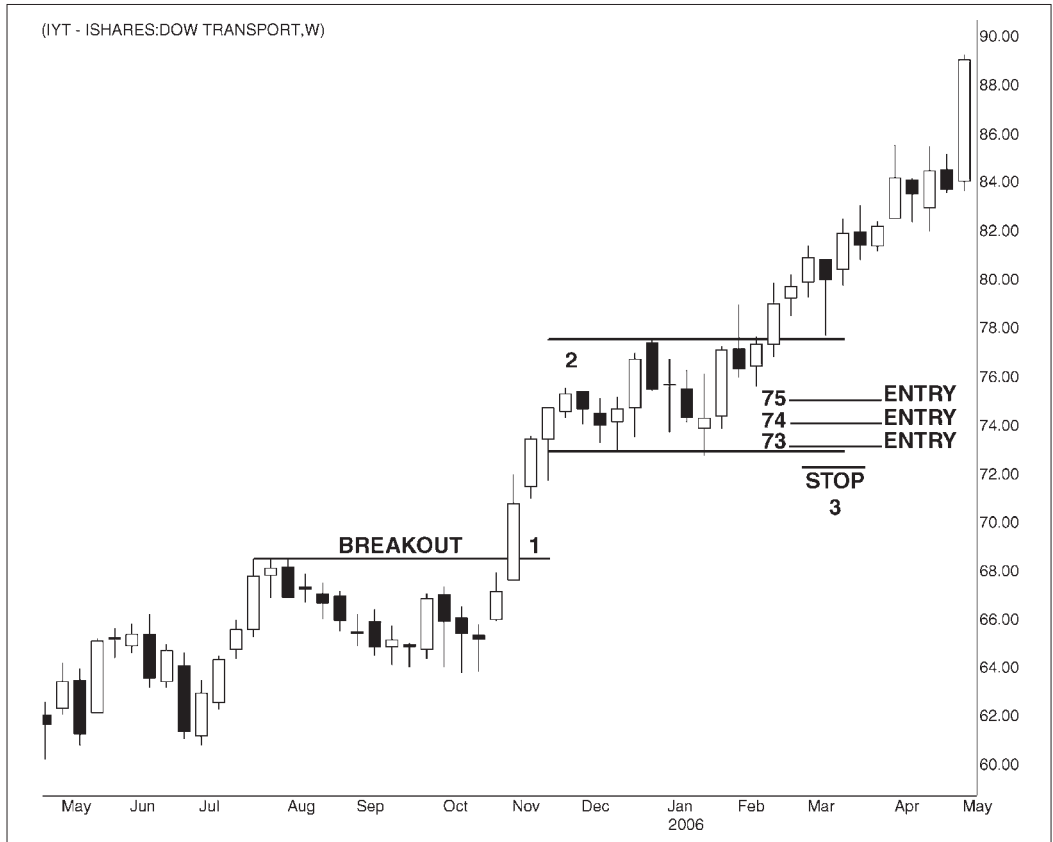
Longer-term charts work well with a part-time trading style because they let us access the markets remotely and still have time for family, friends, and career. Apply this strategy by looking for opportunities on the weekly charts, instead of the daily charts. Review open positions and place new orders during the weekend, leaving the weekdays for the rest of your life. Weekly charts filter out high noise levels and get right to the major trend, but you can't throw money at a long-term chart without picking your entry and exit spots carefully. One effective weekly strategy combines investor and trader techniques, applying the best of both worlds. You do this by entering the position over time, using dollar cost averaging but aligning the trade with major support and resistance levels.

You're stalking the Dow Jones Transportation Average Index Fund for a weekly trade on the long side. Figure 8.2 shows that it breaks out in October (1), rallies up to 77.50, and drops into a trading range (2) with support near 73. An average entry near 74 looks like a low-risk trade, because it's situated in the lower half of the weekly trading range. To fit this number, you enter three reduced-size positions, at 75, 74, and 73, over the course of a few weeks. You then protect the position with a stop loss (3) just under the sideways pattern, near 72.

An alternate entry strategy also works well with this long-term pattern: place a single limit order at the edge of support near 73, and then sit on your hands until that price gets hit. You can refine this strategy even further by breaking the order into two pieces, with one on either side of range support. As I've noted throughout this text, a decline will often

FIGURE 8.2

Long-term transports entry.



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overshoot a big support level before reversing sharply. Splitting the order into two pieces will let you catch that final dip, if there is one.

Both entry techniques will get you into good trades at relatively low-risk prices. Let me emphasize how important it is to remain patient and stalk the setup until the price trigger gets hit. It's real easy for weekly traders to feel left out of the action and to start chasing the market, looking for a quick buck. That behavior will undermine the long-term strategy, which relies on absolute detachment until the precalculated entry price comes into play.

Now here's some great news for the remote trader. Technical analysis actually works better on long-term charts than short-term charts these days

because it's harder for program algorithms to manipulate price direction over time. The natural forces of supply and demand take control in these broader time frames, letting the chart do the job it was designed to do, namely, identify support-resistance levels and predict trends. As a result, moving out on the time spectrum also aligns perfectly with a survivalist trading mentality.

To get started as a remote trader, here are 10 useful techniques to play the long-term charts:

1. Look back at least 10 to 15 years to find every high and low swing that might affect the outcome of your trade.
2. Take small positions and stop using margin. This lowers risk by letting price jump around without shaking you out of good trades.
3. Limit your portfolio to slower movers that are less likely to exhibit sudden or violent price movement.
4. Trade exchange-traded funds whenever possible because you'll avoid company news that sends individual issues through the roof or over a cliff.
5. Keep stops loose and out of the way of the current swing, making sure they'll get hit only if there's a change in the underlying trend.
6. Apply weekly Bollinger Bands set to 20-week and 2 standard deviations. This tool will expose the most favorable periods to enter and exit positions.
7. Trade at the edges of support and resistance, finding the price where weak hands will get shaken out. That's where you want to place your order.
8. Build the position over time with dollar cost averaging, but line up your entries with large-scale support and resistance.
9. Use weekly 5-3-3 Stochastics to identify long-cycle buy-sell swings. Try to buy on the upswing and sell on the downswing.
10. Do nothing until the market planets come into perfect alignment. It's easy for remote traders to get bored and lose their discipline.

Choose less volatile stocks and use physical stop losses, unless you've established a real time alert system. Beyond that, remote trading with long-term charts can be done with great success. However, there's

a real danger if your reach exceeds your grasp, i.e., you get lucky a few times, forget your limitations, and start playing too aggressively. With so many points between major price levels and so much time to kill, it's easy to step into a high-risk situation without realizing it and then fail to get out of the position when things go haywire.

As I noted previously, most traders enter positions that are too large for their experience level or account size. This mistake can be catastrophic with a remote trading strategy. Keep in mind that size equals risk. By reducing position size, you let a financial instrument move over a greater distance without damaging your equity. This helps in two ways. First, you don't have to worry as much about a narrowly defined entry or exit price, because your size will reduce the impact of trade execution. Second, you'll survive whipsaws better, because you can place your stop loss farther away from an obvious support or resistance level and not break the bank.

Avoid market orders entirely if you can't watch as the trading day unfolds. Do your homework and place a limit order at your prechosen price, regardless of where the stock is trading at that time. Then let the market come to you and pick up your order. Never chase momentum if you're a remote trader, because you can't control the increased risk. You can glance at the intraday markets if you really want to, but keep your distance because that rapid-fire price action will prompt you to make bad decisions. Whenever it's practical, save your analysis and decision making for an evening or weekend review. Check progress, adjust stops, and recalculate profit and loss objectives at that time, doing your best to follow the plan to the bitter end, even if hasn't worked well for that particular day or week.

Although you're trading longer-term patterns, you still need fast fill reports and many different ways to get at them. In other words, you want to know as soon as your order gets filled, whether the information comes through a smartphone, computer, or a landline telephone. Fill reports tell you things you want to know right away, including the urgent need to place your stop order. They may also warn of impending danger. For example, you place a limit buy order way below the market, expecting to wait at least a week to get into the position. Instead, your fill report shows up right away. You now know the stock dropped like a rock before it hit your buy order. You could be incurring unexpected risk and need to take immediate action.

THE REAL WORLD: THE NEEDLE IN THE HAYSTACK

Flipping through the charts, doing your nightly review, you see all the things that can and will go wrong with deceptively perfect patterns.

I'm a great cook and like to brag about my culinary skills, but not all my creations turn out for the best. In fact, I recall one time when I ruined a big pot of turkey soup with a single, mindless blunder. I had just bought some fresh parsley, which I had never used in any recipe, and thought the hot brew would benefit from a dose of the herb. Sadly, the aromatic plant completely overwhelmed all the subtleties and flavors of the fresh soup. In the end, even my dog wouldn't consume that ugly green nightmare.

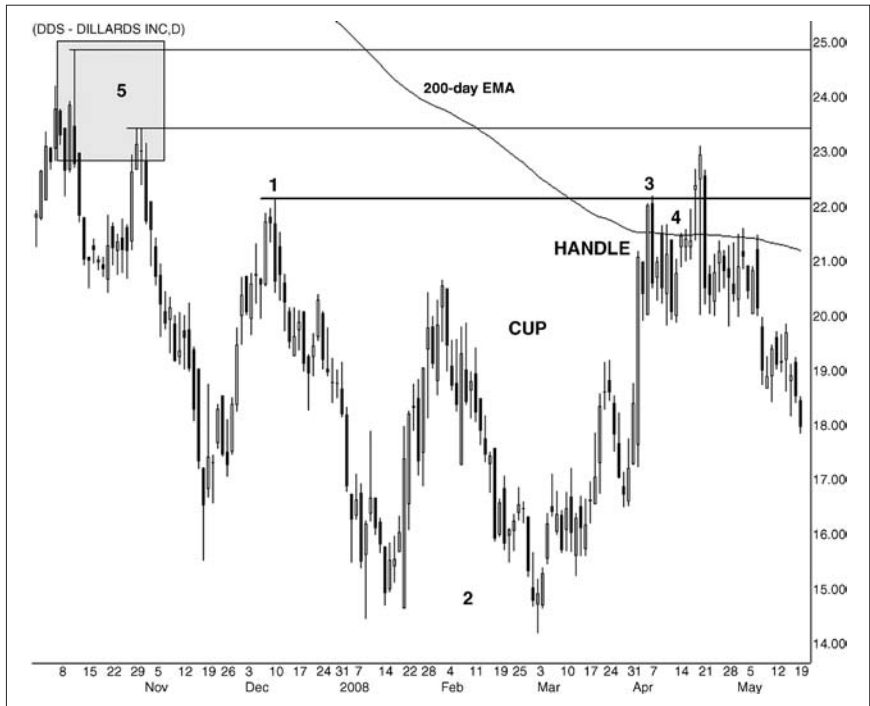
The point of my food tale is simple and direct: one bad ingredient can spoil the otherwise perfect pattern you're staring at right now as you consider tomorrow's trading opportunities. In a word, good trades combine diverse elements that work in harmony to yield predictable outcomes, and it takes just a single discordant element to ruin profit potential. So, when you're cooking up your next position, learn to recognize these trade killers before they put a bad taste in your mouth.

A quick note before I point out a few examples. Perhaps you can dance in the snake pit of mediocre trades and not get bitten, but it's still a dumb thing to do because this is an odds game in which anything can happen at any time. In other words, in order to succeed over time, we must respect the laws of probability and obey them without question. To this end, trade killers reveal price patterns in which the odds are turning against us, sometimes slowly and sometimes with a vengeance. Of course we can get lucky and make money anyway, but in the long run, smart stock picking is our most potent defense against disaster.

Dillard's looks like a dream come true. In Figure 8.3, it rallies up to 22 in December (1) and starts to pull back. The decline ends near 14, where the stock bounces twice (2) and returns to the high in April (3). Price grinds sideways for two weeks and then ticks higher (4), completing a four-month cup and handle breakout pattern, with resistance at 22. In addition, that resistance level has now converged with the 200-day EMA, adding a layer of cross-verification. The bottom line: it looks like a breakout is coming, and we'll be riding the profit wave to high ground. Well, maybe not, because breakouts don't matter when price has no place to go.

FIGURE 8.3

Dillard's cup and handle.



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Look back to the prior year and note how the stock posted lower high swings at 23.50 and 25 (5) just before the December rally. Each of these levels will now act as firm resistance against a cup and handle breakout. Since the lower of the two highs is sitting just one and a half points above the breakout level, that's the total reward we can expect to take out of a well-timed trade. With those barriers in place, the reward:risk profile is skewed sharply against the C&H setup, telling the survivalist trader to stand aside and move on to the next chart.

The moral of the story: it's better to pass on this one and find something that will pay off in a few days, instead of a few weeks—or never.

FIGURE 8.4

Gymboree continuation gap.



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Everyone wants to catch a falling knife, and we all have the scars to prove it. On the surface in Figure 8.4, it looks like Gymboree is grinding through a bullish pullback after a powerful five-wave rally. Prior examples illustrate how a decline into support at a continuation gap (1) can trigger a reliable buy signal for a bounce that retraces a good chunk of the prior decline. But hidden trade killers are telling the survivalist trader that jumping in at gap support on this particular chart probably isn't the smartest play. First, the stock sells off in a hole-in-the-wall gap (2), the one-bar reversal pattern discussed in Chapter 11 of *The Master Swing Trader*. The decline then breaks the 50-day EMA (3), triggering the highest volume day (4) since the September continuation gap. This trifecta of negative price action confirms new resistance at the moving average.

FIGURE 8.5

AutoNation triangle.



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Typical swing dynamics come into play when the stock gaps down into the edge of the continuation gap and then bounces higher (5) in the following session. But the recovery is short-lived, with a second gap down (6) and down thrust that kills the pullback pattern. This follows a useful entry filter designed specifically to protect the trader from this type of scenario. In a nutshell, a selloff into a continuation gap can be bought except when price gaps down to reach the entry target. Even so, the survivalist trader still wouldn't touch this setup with a 10-foot pole because the intensity of downward pressure warned that sellers were in control despite the apparently bullish setup.

The moral of the story: easily observed details often mark the difference between a healthy profit and a painful loss.

It's easy to fall in love with a pattern because you "saw it in a book," but the market usually won't give up its gifts so easily. In Figure 8.5, AutoNation sold off from 23 to 12 and bounced in January (1). The first upswing stalled near 16.50 (2) and gave way to a three-month sideways pattern (3) that carved out an ascending triangle. Nearly all systems were go for higher prices by early May, but two negative factors were undermining this bullish-looking setup. First, an ascending triangle near a downtrend low is less likely to yield a reliable breakout than the same pattern situated near an uptrend high. Second, triangle dynamics require adequate room to run above a breakout level. In other words, the next resistance level needs to be located well above the triangle so that momentum has a chance to catch fire before short sellers have an opportunity to attack the stock. Readers of *The Master Swing Trader* will recognize this open space as "clear air."

Now look back at the long series of lower highs posted in the second half of 2007 (4). This negative pattern tells the survivalist trader there are plenty of bag holders stuck in losing positions at higher levels. Undoubtedly, some of these folks have a long-term view, but others will be looking to sell into any rally that approaches their entry prices. In turn, this overhead supply is likely to act as a deadweight following any triangle breakout. The one-day rally over the 200-day EMA (5), followed by an immediate reversal through support, puts a final nail in the triangle's coffin. This is a perfect location for the start of a new downtrend because it traps reactionary buyers at the same time as it triggers a failure signal that draws short sellers into the action.

The moral of the story: avoid formfitting when you're interpreting a popular pattern. In other words, look at every wart, bruise, or blemish that might undermine a winning trade.

FIVE

P A R T

CONTROLLING EXPOSURE

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9

C H A P T E R

POSITION MANAGEMENT

Traders spend hours extracting the next great setup and then blow the opportunity by screwing up their entry, stop loss, or exit. This isn't a surprise because position management is far more challenging than finding a pretty pattern or uncovering an exploitable inefficiency. We see this dichotomy all the time in the conflict between traders and technical analysts. This is especially true in a culture of keyboard jockeys who believe their ego-based opinions equal financial accomplishment. Of course, that's a popular delusion in our self-absorbed Net-based culture.

Societies and standards have turned the voodoo of technical analysis into a respected field of study in recent decades, but in the real world, you can't make a dime tossing a few trendlines and indicators on a stock, futures, or currency chart. Rather, every penny of profit needs to come from good trade decisions made in the heat of battle or through a pre-planned strategy that's executed with precision. Even system traders are forced to make great decisions, although the majority of those judgments come when they're preprogramming their machines rather than watching

the real-time ticker tape. In both cases, however, the smartest folks are matching their buy and sell decisions to the flow of market energy in the form of index futures, shock events, and relative strength oscillations.

I outlined a laundry list of differences between spectators and speculators in Chapter 7. Similar battle lines can be drawn between the mental process of finding a good-looking pattern and the emotional process of risking capital on that discovery. In the real world, the first skill set can be taught to students in a matter of weeks or months. The second, however, will take years or decades for the handful of folks who actually master it. Sadly, everyone else will finally give up when they realize the elusive goal is far beyond their capacity, willpower, or knowledge base.

Here's an experiment. Go out and find 10 good traders. Then have 5 of them go long and 5 go short on the same financial instrument. As odd as it might sound, all 10 traders can easily make money. This is a deep Zen-like truth that's tough for logical and linear brains to understand, but your long-term success actually depends upon it. This paradox focuses squarely on two gray zones that marginal traders would rather ignore:

- All price movement is bidirectional, with trends within trends within trends.
- *When* you buy or sell is far more important than *what* you're buying or selling.

Survivalist traders internalize these twin commandments and incorporate their major impact into daily position management. They also understand how a few moments of inattention or a lapse into mental cheerleading can turn a surefire winner into a frustrating loser. After all, that's the nature of market timing, where windows of opportunity open and close in rapid-fire succession. The vast majority of time, however, will be spent dealing with the number one enemy of market players worldwide, better known as mind-numbing boredom. Price action in all venues oscillates between long periods of meaningless noise and relatively short bursts of directional signals. The survivalist trader learns to recognize which state is currently active and then adjust position management in order to accommodate it. This bilateral mentality requires sitting on our hands through broad stretches of nonopportunity and then jumping around like crazed squirrels when the market finally wakes up and starts to move higher or lower. As we all know, flipping this mental switch isn't an easy task, and we often find ourselves chasing old trends that have died out or standing on the sidelines long after new trends have taken control of the tape.

Traders need intimate familiarity with the intraday markets in order to distinguish between periods of opportunity and nonopportunity. Even setting stops on long-term positions will benefit from understanding how intraday ranges affect the odds of those levels getting hit. Correct interpretation of intraday price action starts with the flow of buying and selling pressure, as observed in the index futures, and then considers the impact of those oscillations on the patterns being traded in that session. As with a puppeteer and his marionette, nearly invisible strings connect the two entities, generating an intricate flow of movement, emotion, and storytelling.

BUILDING INTRADAY SKILLS

1. **Have a proactive plan for the first and last hours.** Experienced traders can play these periods aggressively, but newer traders should just sit on their hands.
2. **Become a student of time of day tendencies.** Markets tend to trend within narrow time windows, while fakeouts take control for the rest of the session.
3. **Choose a set of intraday indicators and then leave them alone.** Learn to interpret conflicting information rather than searching for the perfect signal.
4. **Stalk the NYSE TICK.** Watch for intraday highs and lows that might define an entire session. TICK has a life of its own and will save your neck if you let it.
5. **Keep one eye on your positions and the other on the indices.** When a position moves more sharply than an underlying index, it should continue to do so.
6. **Look for breakouts and breakdowns of two- and three-day trading ranges.** These short-term swings will tell you if your positions are trending or running in place.

STOPS

Stop placement is a difficult trading skill to learn and a lifetime exercise in frustration. Price bars overlap in all but the most dynamic markets, which means your positions will crisscross the same levels over and over again

before trending higher or lower. This sideways chop undermines stop placement when you're trying to protect a small gain and the big prize at the same time, because the two goals are often incompatible. In other words, it's easier to take a little money out of the market than to hold on to a lot of it.

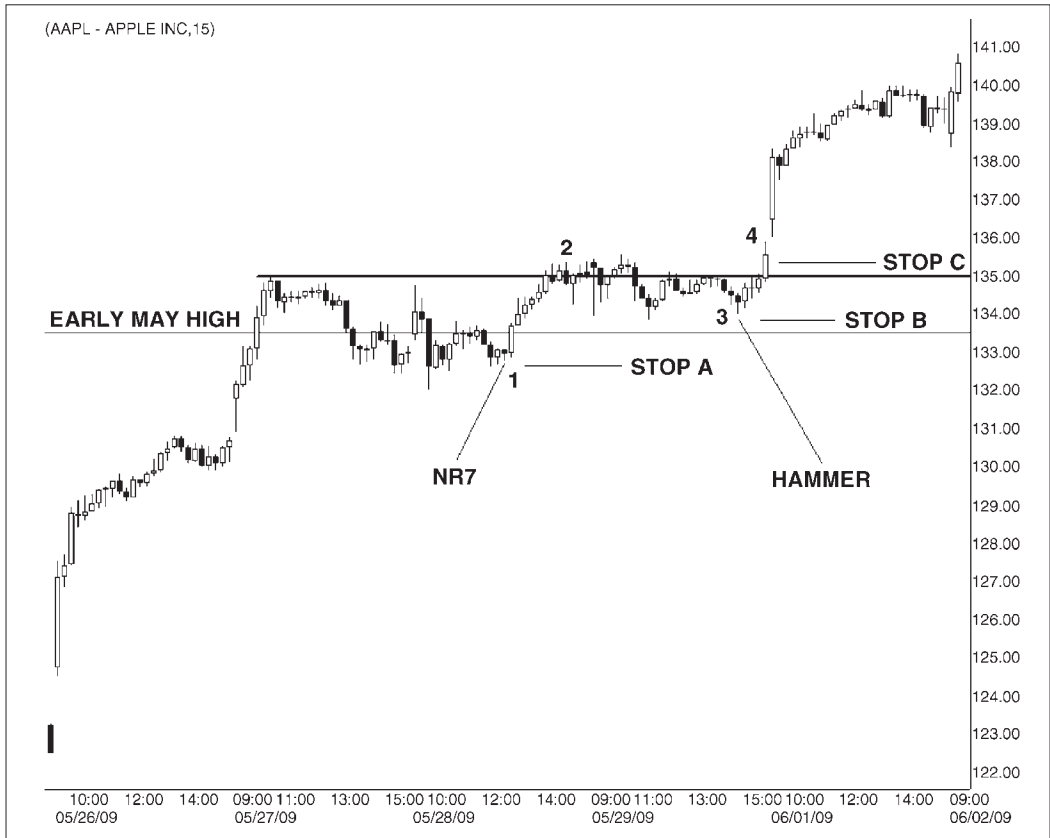
How often has this happened to you? You see a trade setup and jump in at the perfect price. The position turns a profit in the early stages, but you wind up losing every penny because your stop gets hit just before the instrument reverses and moves sharply in your favor. Fortunately, you can avoid getting shaken out of good positions by using one of two radically different approaches to stop placement:

- Place the stop well outside the market noise while at the same time keeping the loss within risk tolerance.
- Place the stop in a lower time frame, using data gathered from the short-term price action. Keep reentering, as needed, until the total loss hits risk tolerance.

In Figure 9.1, Apple rallies to 133.50 in early May and pulls back for nearly three weeks. It surges back to the high on May 26 and breaks out the following morning. This price action initiates a new action-reaction-resolution cycle that can be managed easily on the 15-minute chart. The buying surge (action) stalls at 135 and gives way to a consolidation (reaction) pattern. We want to buy the breakout, within the sideways pattern, in order to take advantage of an expected follow-through rally (resolution) over 135. The first buy signal comes when the stock jumps out of narrow range (1) at 133 on May 28. It's harder to trigger a failure swing when price shifts from a low into a high volatility state, so "short-term" stop A is placed just below the NR7 bar. The next buy signal comes when the stock pushes above the two-day high at 135 (2). A fresh entry in response to that breakout is likely to lose money, no matter where the short-term stop loss is placed. The shakeout then continues for over a day, with price spiking lower four times. The fourth downdraft posts a slightly higher low (3), triggering a buy signal because it predicts that whipsaws are finally coming to an end. We take a fresh entry and place a short-term stop B just under the small hammer candle, which should work nicely if our buy thesis is correct. The stock then gaps out of congestion, triggering a clean breakout (resolution) that signals our fourth entry. Placing short-term stop C just under the level where the gap would get filled makes perfect sense because we expect an immediate momentum surge in line with the dynamics of a resolution phase.

FIGURE 9.1

Apple short-term stop losses.



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Most traders place their stops in the same old places, so they become attractive targets for the smart money and their wickedly accurate computer programs. To keep that big target off your back, learn to avoid stops at common hot spots like trendlines, round numbers, and moving averages. In fact, it's best to avoid stop placements at any logical level because they become magnets for stop gunning events, especially before price jumps in the opposite direction. These frustrating "rinse jobs" seem unfair to traders, but they're a fact of life in our modern markets. Hey, no one ever said this game was easy.

Stay in the trade as long as price action shows you're right, but exit immediately when proven wrong. Your stop loss needs to address this

potential failure because each position has a price that smacks us across the face and tells us our point of view is no longer valid. For obvious reasons, this is the natural location for the stop loss, which is then modified through analysis of recent trading ranges to avoid getting caught in a rinse job. In addition, your trading plan needs to confirm that stop placement matches your intended strategy. For example, if you're looking for a multiday move, pull the stop back and risk more capital in the initial stages of the new trade. Conversely, if you're planning on a quick scalp, press the stop against the advancing stock, futures contract, or currency pair, and just take what the market gives you.

Divide your stop loss strategy into three risk segments: initial stop loss, trailing stop, and exit stop. Then apply each technique at the appropriate time in the position's evolution. This three-step process forces the trader to identify the profit target before entering the position. As discussed in Part Two, each trade has an intended exit defined by the next support or resistance level, reduced by interim barriers. This is your profit target. In other words, your pretrade analysis looks at prior swings and zeroes in on the price level you expect your position to reach within the intended holding period. Simply stated, profit targets are vitally important in the third and final stop phase because they tell you when to shift gears and to aggressively protect profits.

The trading strategy for initial stop loss placement is very simple—put it where the pattern is broken, if price gets there, or apply the short-term strategy outlined in the Apple example. Every trade has a good reason and a bad breaking point. For example, if you buy a stock because it drops into a trendline, the stop loss needs to go on the other side of the trendline because your assumption is proven wrong if price hits it. Of course, this placement doesn't work all the time because modern markets routinely charge through trendlines, take out stops, and jump back across support or resistance.

These rinse jobs give us just three logical stop modifications:

- Place the stop loss deeper in the pattern and take more risk.
- Take the loss at the logical price and reenter when the instrument reverses.
- Find patterns where entry and stop loss are placed at nearly the same price.

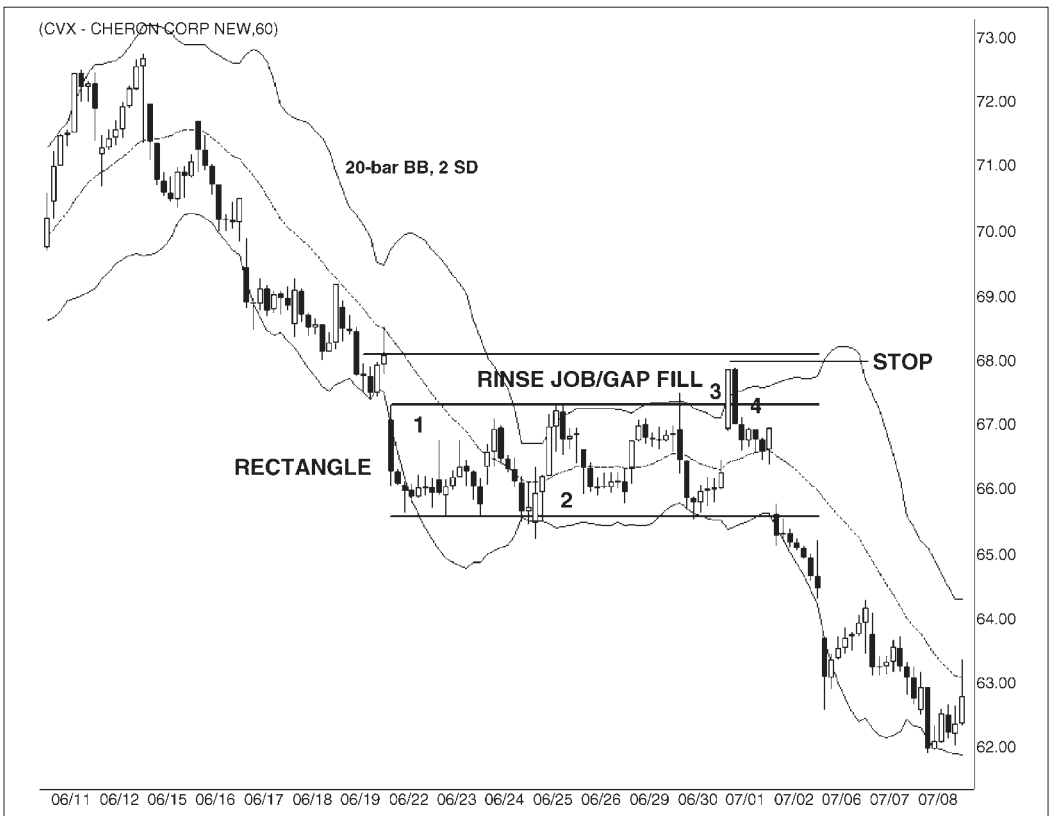
The most reliable placement strategy identifies lower-risk entry prices that let stops stay outside the line of fire. Start by identifying support-resistance bands near the edges of common patterns. These price extremes

serve two purposes. First, they'll tell you when your existing stop loss is in mortal danger. More importantly, they'll identify execution levels for new positions. These extreme entries match up with exceptionally tight stop losses that are out of harm's way.

Don't shift into profit protection mode until the time is right. This means keeping your distance until the trend ejects in your favor through wide range bars. It's normal for price to wiggle between profit and loss in the early stages of a new position. It's your job to remain patient as long

FIGURE 92

Stop gunning is a good way to lose money if already positioned and a great way to make it when coming off the sidelines. Chevron sells off in a steady decline, finally gapping down (1) to 66 on June 22. Short sellers enter the rectangle pattern (2) in the next week and place covering stop losses just above resistance at 67.25. Price shoots through the top of the rectangle (3) on the first day of July, triggering those stops and filling the gap. The next hour's reversal signals a low-risk short sale entry (4) because the stop loss now can be placed less than a point above the 60-minute high.



as the technical pattern stays intact. A good trade is like tending a garden: you need to give it a little love, pick the weeds, and let it grow. Eventually, the instrument jumps away from your entry and ramps up or down to a new price level. Now's the right time to apply your first trailing stop by dropping down to a shorter-term view. Pull up a 60-minute pattern to place the trailing stop if you're trading off the daily chart, or a 15-minute pattern if you're trading off a 60-minute chart. In either case, examine recent action for rangebound bars between your initial entry and the current price, placing the stop just behind one of these congestion zones.

Why place your trailing stops at these levels? Look at it this way. A breakdown on the daily chart will begin with a reversal on the 60-minute chart, while a breakdown on the 60-minute chart will begin with a reversal on the 15-minute chart. Using this zoom-in stop methodology, you keep a bigger piece of your hard-earned profit if the dominoes start to fall and the market turns against you. Once established, move the trailing stop each time that price ramps to a new level and deposits a sideways pattern on the intraday chart. Continue this process until the position reaches about 75% of the distance between the entry and the profit target. Then shift to the third and final phase, pulling your trailing stop aggressively behind advancing price.

It makes absolutely no sense to risk dollars in order to make pennies, but this is exactly what happens when price approaches a profit target. You originally chose this level because of significant support or resistance, but there's no guarantee your trading vehicle is going to hit the price dead on before reversing hard. So, it makes sense to draw in your trailing stop to guard the profit in case the market turns around earlier than expected.

Transitional price behavior near a profit target can also give you an opportunity to squeeze the last dime out of your position. After placing your final trailing stop, enter a second stop above the market on a long position or below the market on a short position, right at the profit target. Using this predatory approach, you'll get filled immediately if price charges into its final destination. And, while counting your profits, you'll be amazed at how often you've caught the exact reversal price while you watch other traders crash and burn in the ensuing turnaround.

SURVIVALIST STOP STRATEGIES

All of us study the same trading books when we start playing the financial markets. Unfortunately, these classic tomes lecture us on stop loss

techniques that don't work anymore. The problem lies in a broad assumption that technicians are a trading minority and can safely place stop losses just behind common support or resistance levels. Legions of new traders follow these instructions to the letter, entering at identical locations. On the surface at least, the activity makes sense because these inflection points follow the natural rules of risk management. Sadly, no one ever tells these folks they're being led to slaughter. Simply stated, financial instruments will gravitate toward price levels that will hurt the most traders over time. A strong trend can overcome this diabolical force for a few days or a few weeks, but that's usually the exception to the rule. The rest of the time, this target-on-back magnetism is the overriding influence on short-term price direction.

Every fund, institution, and survivalist trader knows there's a pool of liquidity sitting at common stop levels, waiting to be tapped. It's even dangerous for defensive stops placed outside of obvious support and resistance levels, because dumb money stops triggered at big numbers can start a domino effect that takes out orders for many ticks beyond the initial casualties. You'll avoid a ton of trouble by locating common stop levels before taking the trade. After these magnetic targets are identified, go back and see what happened the last few times that advancing or retreating price hit them. Were there big spikes through support or resistance that quickly reversed? If so, commonly placed stops aren't likely to survive.

The only effective way to avoid these slash-and-burn dynamics is to keep stops far away from all attractive levels. This is easier said than done because stop placement forms the core of our trading plans, and when losses can't be taken at expected levels, everything else must change to accommodate the new risk equation. In other words, the altered trade that responds to this added danger must be taken at a more advantageous price level vis-à-vis the new stop loss. It makes perfect sense that traders can't change their stop losses without also changing their entry prices. Therein lies the problem. We want to place stops that won't get hit, but we don't want to change the way we enter our positions. In fact, most traders are so reactive they'd rather lose money by chasing stupid entries than deal effectively with the inevitable rinse job. As I noted in Part Four's discussion on anticipation versus reaction, the most common entry technique reacts to a breakout or breakdown, following the crowd into the position. It's a fact of life that many traders never learn any other market strategy. Sadly, there are just a handful of ways to defend against the rinse job when using this reactive style to enter the market, because positions are taken far above or below support-resistance levels. In turn, it's the most direct path to failure for most market players.

If you insist on playing the reactionary momentum game, flat dollar or short-term moving average stop losses are the only methodologies that make sense. For example, you take a breakout position and place the stop 20 cents, 50 cents, or a dollar behind your entry, based on the maximum loss you're willing to take if it gets hit. There isn't much rhyme or reason to the process because it isn't based on the technicals of the pattern you're trading. Moving average stops are more proactive because they're responding to real-time price action. This method is even simpler—just pull up an 8-bar SMA on the 15-minute chart, and exit the trade if price violates it. For larger-scale breakouts, or if your stops are getting hit too often, use the 8-bar SMA on the 60-minute chart instead of the 15-minute chart.

Whenever possible, avoid percentage-based stop losses such as 5%, 10%, or 50%; they say absolutely nothing about the current market or trade risk you've just assumed. For example, you enter a position where a volatile stock is moving 11% each day, on average. This means your 10% stop is at risk due to market noise and absolutely nothing else. A percentage-based stop loss also gives the illusion that you're controlling risk without addressing the true nature of risk in the first place. This is vitally important because reward and risk are joined at the hip. Simply stated, if you don't get one right, the other won't be right either. In reality, there is a measurable risk based on the specific pattern and the price you enter the trade. Each position has a different risk profile, with your entry price telling you exactly how much it can wiggle around and still get to the final goal or profit target. You need to include this standard deviation data in your stop planning, or you'll take maximum loss after maximum loss until you wash out of the markets.

The most reliable stop-sensitive strategies force traders to get positioned very close to their initial failure targets. This requires waiting for a deep pullback that may never come, or using stop loss magnetism as an entry tool. In other words, stand aside until the commonly placed stops are run, and then jump in as soon as momentum fades. This entry technique was highlighted in the Chevron example earlier in this chapter. This type of entry isn't for the faint of heart because it triggers during periods of high volatility, but it will work with surprising reliability. After a long-side entry, place the stop loss one tick below the rinse job extreme. It shouldn't get hit because magnetism has taken out one side of the market and generated a short-term imbalance that should trigger mean reversion dynamics. And, ironically, the rinse job often precedes the start of a strong trend in the opposite direction, which makes it a valuable leading indicator in addition to its role in finding superb trade entry levels.

OVERNIGHT HOLDS

I was a committed day trader through most of the 1990s, like so many folks in those happier days. I made the switch over to swing trading late in the decade for a number of logical reasons. First, the frenetic pace of day trading drove me absolutely crazy. Practitioners of this anxious art are forced to make critical decisions in a noisy environment, overwhelmed by bad data. Thanks, but no thanks. Second, I'm more confident in my trading edge when holding positions for a few days rather than flipping them every few minutes or hours. Realistically, I still do a fair amount of day trading, but it's evolved into a defensive strategy during periods of increased risk, or when overnight opportunities become scarce. Curiously, many current day traders confess they'd rather be swing trading but believe that holding positions overnight is too risky. In my view, they're dead wrong.

Learn how to use the overnight markets to your advantage, and don't be fooled into thinking there's too much risk in holding positions at the end of the day. In fact, most profits are created between the close of one session and the start of the next one. While it's true that day traders avoid the uncertainties of the overnight markets, the sword cuts both ways because every instrument thrusts away from an entry price as a function of time. As a result, intraday profits tend to be a lot smaller than overnight profits. Micro holding periods also frustrate attempts to raise winning percentages because day traders need to exercise perfect timing over and over again. In contrast, overnight traders can survive tons of whipsaws and losses and still book substantial profits. Realistically, day traders can control losses more efficiently than overnight traders, but the practice unravels this market edge through higher noise levels and transaction costs.

Of course, there are legitimate risks when carrying positions overnight. News shocks can trigger nasty gaps, while earning surprises can hurl stocks into unexpected places. This danger is especially high in rangebound or conflicted markets. However, you can overcome the majority of overnight risks with a good trading plan. Above all else, stay informed and don't get blindsided by economic releases, options expiration, or other cycles that impose their will on market direction. And never, ever hold a position through an earnings report unless you're protected by options hedging. You don't know how the report will move the company's stock, regardless of your high or low expectations, so the only logical path is to stay on the sidelines and let other traders assume the risk. However, as I noted in Part Two, it's perfectly OK to trade *into* earnings because that speculative period is often filled with dumb money and great opportunities.

Holding stocks over the weekend frightens risk-conscious traders, but the strategy is even more profitable than overnight positions taken during the midweek. Why does it work so well? Consider all the weekend warriors looking for new stocks to buy when the market opens on Monday morning. Their furious hunt increases the odds that a broad audience will discover the issue and bid up prices as soon as the new week begins. In fact, this is one reason for the classic turnaround Tuesday bias. It goes something like this: Public traders come pouring into the market on Monday, chase

FIGURE 9.3

Urban Outfitters sets up a low risk overnight opportunity after it carves out a two-month, 120-minute cup and handle breakout pattern. Price surges above resistance (1) at the opening bell on July 29 and pulls back in a sharp reversal. The stock finds its low quickly and spends six hours creeping higher in a steady uptick, but it doesn't remount resistance. Observant traders can get on board just prior to the close and catch every penny of the next morning's breakout.



prices to higher levels, and then sit back, waiting to get paid off. The next morning (Tuesday) comes, and those positions are targeted aggressively until the weaker hands cry uncle and exit the market.

Lower your overnight risk by examining price history and noting how often the instrument gaps compared to the broad market. This simple analysis gives the survivalist trader an important edge with overnight positions because many charts have a gap signature that shows a consistent pattern in the trend direction, or vice versa. When this analog review points to unexpected risk in holding overnight, take an early exit and reenter the next day.

Train yourself to press positions in trending markets and defend them in sideways markets. It might sound obvious, but overnight positions incur less risk when long in a strong market or short in a weak one. It also makes sense to extend the holding period in a trending market and to become a rapid-fire day trader in a sideways market. Of course, it's logical that rangebound markets support fewer overnight holds and tighter stop losses. Alternatively, it's time to get more aggressive when a market, sector, or instrument starts to run. In the real world, 80% or more of your annual profits will come in just 20% of your trading days. This means you need to be in the market, and stay there, when prices start to trend higher or lower.

Reduce position size if you're nervous about overnight risk. You can also take partial profits just prior to the close and carry a free trade into the next day. Then, if the market opens flat or favorably, you have the option of adding back into your position. On the flip side, doing nothing is often the best strategy when the market moves against your overnight position. A major purpose of opening volatility is to shake out weak-handed traders and investors, but this time of day often prints the least favorable exit prices. In fact, adverse openings often present an opportunity to add to positions, but two things must happen first. First, the newly bought shares must be part of a predetermined plan that's building the position over time and at different price points. Second, the opening levels must not violate the pattern that got you into the trade in the first place.

Trading books tell us to look for follow-through on the session after a financial instrument closes near its high or low. They even publish impressive statistics to support this classic profit-building technique. The problem is, it just doesn't work anymore. Computer programs have killed the strategy, even with short positions, because algorithms can turn the strongest trends on a dime and trap overnight trend followers. So, rather than lose sleep, just resign yourself to the fact you're going to get beat up

from time to time when a great overnight play doesn't pay off as expected. Don't let those losses stop you from holding overnight positions because your equity curve over the course of weeks or months should prove the value of this meat-and-potatoes strategy. Yes, terrible things can and will happen to your overnight positions, but it's more likely they'll work out just as expected. Since all trading relies on odds management, the real issue is how overnight positions perform on average over time. In other words, a percentage of overnight positions will suffer from exposure to shocks and adverse news events, but natural trend development should outweigh those losses and support profitability as long as traders apply a rigorous stop loss strategy.

END OF DAY CHECKLIST

Here's a common scenario. The equity market is winding down toward the closing bell. You're sitting on a bunch of stocks but don't know which ones to dump and which ones to hold overnight. It's the perfect time to ask 10 questions to determine your exposure heading into the close:

- 1. Did you buy in quiet times or wild times?** It's better to buy stocks that are relatively quiet that day, in hopes of catching a big move in the following session. This makes them less vulnerable to profit taking or a reversal. Alternatively, if you've jumped into an active trend, it's harder to predict where price will open the next day. In fact, you have about the same odds of making and losing money. The bottom line: it's never a good idea to hold overnight on a 50-50 coin flip.
- 2. Did you miss your first exit?** Profitable exits come in cycles. In other words, your position will move into a point of maximum profit that's easy to miss if you get too greedy. It then drops away from that price while the intraday clock ticks toward the closing bell. Holding overnight lets the stock recycle, so you get another shot at the exit you missed the first time around.
- 3. Is the market closing with pressure on the upswing or downswing?** Look at the 60-minute index futures. Do the 5-3-3 Stochastics rise or fall into the closing bell? Falling Stochastics suggest the market will open weaker in the following session, while a rising indicator predicts higher prices when you wake up the next day.

4. **What day of the week is it, and what's on the calendar?** Look for reversals or whipsaws on turnaround Tuesday and continuation of Tuesday's trend on Wednesday. A strong close on Friday should yield a strong open on Monday, except after an expiration week, when Monday's session often reverses Friday's close. Pull up the schedule for the following day and see how many economic reports will hit the wires just before the opening bell. Consider how that data might impact current sentiment.
5. **Who's getting hurt in the current session?** The diabolical market puts its target on a different back each day. That's why rallies and selloffs rotate across diverse sectors in a typical week of trading. Look for sectors to recover after two down days or to sell off after two up days. If those cycles run contrary to your positions in the final hour, dump them and look for opportunities that match other rotational events.
6. **What is your holding period for the position?** Stick with your trading plan. Did you set a holding period and profit target when you bought or sold short? If so, don't allow that day's noise to interfere with your strategy. In particular, don't base your exit or hold decision on the current profit or loss, as long as your reasons for getting into the trade remain intact.
7. **Which companies are reporting earnings after the closing bell?** Get out of the way if your stock, or a leader in a related sector, is scheduled to report earnings after the close. Trading is never about gambling or "taking a shot." It's about assuming risk when you have an edge and the odds are in your favor. Absolutely no one can predict the market's reaction to a single earnings report with any degree of accuracy.
8. **What total size should you carry overnight?** Decide how much risk you can handle and still get a good night's sleep. Consider how much danger there is in the market at the specific time, and apply an overnight collar. Are you trading in quiet conditions or an environment where everyone is walking on pins and needles? For obvious reasons, take home smaller size in periods of higher volatility.
9. **Why is your position ending the day at that particular price?** Stocks move around for many reasons. Most of the time they're reacting to high noise levels (passive) rather than buying or selling pressure (active). The best ones move in your direction because they're active, or against your direction because they're

passive. Consider adding to passive movement against your position if it fits your risk tolerance.

- 10. What should you buy or sell right now to balance your exposure?** Consider new stocks to take home. These might include a favorite play selling off into support or a hot rocket that's faded after a morning run. The trick is to find bargains and not stocks that other traders have already tapped out.

10

C H A P T E R

MASTERING THE INTRADAY MARKET

The survivalist trader needs accurate feedback on open positions to take advantage of directional movement and to guard against traps, rinse jobs, and other unwelcome surprises. The best way to accomplish this daunting task is by observing and managing exposure continuously in the intraday markets. While watching every tick isn't a viable option for many traders, it's the preferred management route whenever possible. The remote strategies outlined in Part Four offer a useful alternative to folks with real lives away from the financial markets or commitments that keep them from the ticker tape.

In the real world, some positions will behave very well, while others go haywire and fall apart. This duality forces the trader to establish an adaptive profile that denotes the prechosen exposure and risk associated with all open positions. This macro control mechanism needs to match external market conditions which in turn require constant adjustment through position choice, share size, and holding period. The adaptive profile is far more important in a successful market strategy than any

individual trade. The financial markets cycle through phases of danger or opportunity. It's the trader's job to identify the current phase and adapt, in real time if possible, by applying the right collar for that particular market. Collars signal when to let profits run, and when it's the worst thing you can possibly do. They also define the right stock, futures contract, or currency pair to trade at any point in time. For example, it makes perfect sense to play volatile small caps when the collar is loose and the market is printing money but to stick with blue chips when opportunity is low and predators lurk in every dark shadow.

Adaptive profiling establishes the collar placed on each day's market activity. This refers to the aggressive or defensive posture based on volatility, sentiment, and current positioning of the index futures. In a nutshell, the survivalist trader needs to be aggressive in times of greatest opportunity and defensive in times of greatest danger. This is one of the more subtle aspects of intraday strategy, because it demands a central theme that changes from day to day. Part Six will address this aspect of position management in greater detail.

READY, SET, GO

You've reviewed the trade setup a dozen times, calculated reward:risk, and found the perfect moment to enter the market. With a slight adrenaline rush you hit the magic button and open a position. Now what do you do?

First, digest feedback from the fill report. With a market order, your entry might show slippage and demand a recalculation of trade assumptions. So, if you get filled more than a few ticks away from expectations, reconfirm risk tolerance and recalculate the intended exit in case things go wrong. Next, take a second look at the charts to confirm that you made the right choice. We often see things differently when sitting on the sidelines, as opposed to being in the heat of battle with real money at risk. Finally, set a physical stop if that's part of your trading plan. If not, target the price or specific conditions under which you'll exit the position without hesitation.

Take your losses manually, whenever possible. This builds discipline because the action accepts responsibility for the trade. It also acknowledges how your stop loss points to an evolving calculation and not a fixed number. Update this mental escape hatch as each price bar

modifies your assumptions, goals, and emotional state, getting out immediately when price hits the level where the trade proves to be wrong. The failure swing that demands your exit might turn out to be a whipsaw, but don't delay action in an effort to find out the truth. A trade can always be reentered after a shakeout, but each position must stand on its own merits. This unbending rule requires a fresh analysis and revised targets for each entry. Keep in mind that subsequent trades often fail because the initial shakeout actually signaled a legitimate change in trend. If a weekend evaluation suggests you're getting shaken out of good positions too often, then it's time to revise your stop loss strategy so that trades are given more room to run.

Intraday charts sketch feedback in real time. Watch price action and anticipate how individual bars on 15-minute and 60-minute charts will close. Pay close attention to how buy and sell ticks affect the curvature of surrounding Bollinger Bands and evolving Stochastics. Watch out for thrusting candles that break through the top or bottom band, signaling a momentum peak. Look for small but significant gaps between candles at key price levels. Find the spot where the pattern says the bars should eject into a profit or break down into a loss. Then see if the buy-sell order flow matches your expectations. Measure the market's pulse through 5-3-3 Stochastics. When a notable surge of buying or selling pressure doesn't push price firmly in your favor, it may signal hidden supply or demand that will eventually trigger a reversal.

Use position scaling to address changing risk. Take partial profits when trades stretch toward profit targets ahead of schedule. Reduce size when price action gets erratic or external forces make prediction more difficult. Double or triple up when patterns fire on all cylinders or unexpected news lends support to an open position. In other words, trade larger when you're getting clear signals, and reduce size when forces are in conflict.

Each position has a right size, regardless of account capital. This risk level shifts as price bars add fresh data into the trade feedback loop. Load up during winning streaks and supportive markets because performance implies reduced risk. Lighten up and wait for better times when you're experiencing drawdowns or reversals of fortune. Inexperienced traders expose themselves to risk because they think total buying power must be committed to each position. These folks will survive a lot longer in the financial markets if and when they just learn to trade well, and stop worrying about making money. In the real world, profits come automatically when we take the time to become proactive managers of our open positions and apply the right collar to each trading day.

TAPE READING

You can't become a successful trader without mastering the fine art of tape reading. That revelation could be a shock after the countless hours you've spent studying the charts and probing the indicators. Of course, you can trade without the tape, but you do so at your own risk because the charts paint pretty pictures that trigger perfectly wrong signals. Meanwhile, the flow of buying and selling pressure, as it unfolds on the ticker tape, exposes forces that remain hidden to charting purists. In a nutshell, those impulses uncover the real activities of market players, as opposed to the smoke and mirrors being fed to the trading public. In a word, the tape never lies.

When students ask me for a seminar on tape reading mastery, I usually tell them to sit down, pull up a notepad, and watch the numbers wiggle around for a few decades. They think I'm kidding, but I'm not. Literally, it can take 10 years or more of staring at the shifting numbers to decipher the games played by Wall Street and other market participants. However, it's worth the considerable effort because, once you've learned to read the tape, you have a lifetime edge over less observant traders.

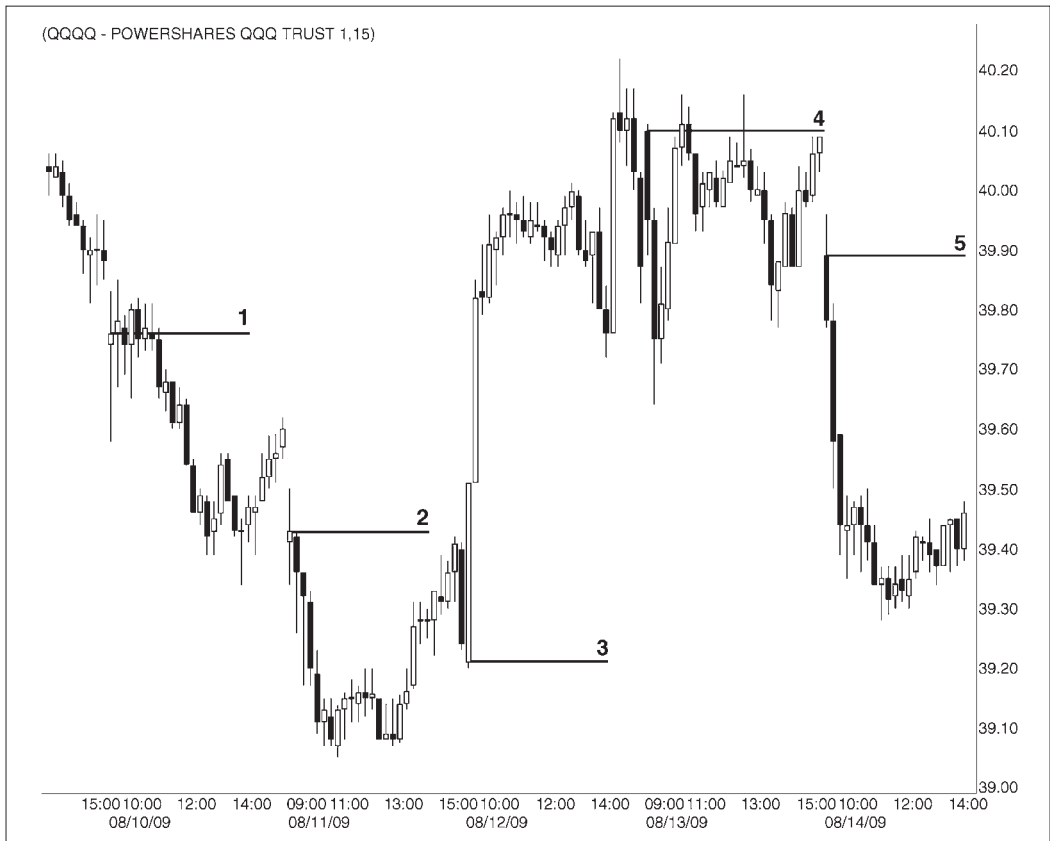
Here's a tape trick to get a read on the crowd's excitement level. Place a 30- or 60-day moving average of volume next to the real-time daily volume on your watch lists. The few issues that pace above their moving averages signal impending range expansion for that session. This side-by-side analysis works best when macro influences aren't moving the broader tape. For example, a stock trades over 50% of its 60-day average volume in the first hour of the trading day although it's stuck in a narrow range. You're staring at an actionable signal that could yield a major rally or selloff by the closing bell.

Veteran trader Larry Pesavento points out a powerful tape reading tool called the "opening price principle." Through years of observation, he discovered how the opening tick frequently serves as a pivot through an entire session. This comes into play in many ways but is most useful when price returns to retest the opening level, from above or below. To use this tool, draw a trendline across the opening prices on the S&P 500 and Nasdaq-100 index futures or their related funds. When price action retraces back to those levels during the intraday session, watch closely for a breakout, breakdown, or reversal, using those swings as trading signals for individual equities.

In Figure 10.1, the opening price comes into play five sessions in a row on the Nasdaq-100 Trust (previously the Powershares QQQ Trust). Price tightens into narrow range (1) for nearly two hours on the first

FIGURE 10.1

Nasdaq-100 Trust opening price.



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day, with the opening price marking the center pivot of a triangle that breaks to the downside in a steady selloff. The fund gaps down (2) on the second day, selling off into the lunch hour and then bouncing higher. The recovery stalls just a few cents from the opening price, which now marks resistance, and drops like a rock in the close. Price opens marginally lower (3) in the third session and zooms higher in a trend day that never retests the opening level. Whipsaws (4) hit the market on the fourth day, with upswings reversing at the opening price twice during the volatile session. The last day yields another downtrend (5) as selling pressure slams the market right at the opening bell. Note how the opening price comes within eight cents of marking the daily high.

Tape readers pay close attention to the relationship of current price to the daily range. Real-time quotes refer to this ratio as the “% in range.” This simple number can track the progress of a huge basket of financial instruments in just a few seconds. For example, there’s an hour to go and the market is down. Most of your watch list is scraping the bottom third of the daily range, but one or two stocks are popping near 100% on the % in range quote. These leadership issues are breaking to new highs while the rest of the list is doing nosedives with the broad market. Guess what? You’ve just uncovered a bullish divergence for momentum plays into the close or an overnight hold, in anticipation of a morning reversal.

A simple display that shows only the last price traded and the bid-ask spread provides most of the data needed to read the ticker tape. The time and sales screen is helpful but not essential to your task, and I’d avoid the Level II screen entirely because it’s just a distraction. There’s a misconception that tape reading and technical analysis are separate but equal paths to market mastery. In truth, the effectiveness of your tape observations comes from identifying critical chart levels where buyers and sellers clash, with one side or the other finally taking control. When you uncover one of these contested levels, sit back and watch as the battle unfolds, understanding it might rage for hours or end in a few minutes. Look for a defense of the boundary and if there’s enough excitement to overcome it. Decide whether the bulls or bears seem more determined and in control of the tape. What doesn’t happen during these conflicts is just as important as what does happen. For example, price lifts into a key resistance level, where sellers should be attacking the bid and attempting to trigger a reversal. Minutes pass, but no selling pressure emerges. This lack of activity yields a bullish divergence, telling the tape reader that bears have stepped aside for whatever reason, allowing bulls to trigger a breakout and much higher prices.

The most basic order flow manipulates price against crowd emotions. Simply stated, the ticker tape knows the chart better than you do. In a typical scenario, professionals and their program algorithms keep one eye on stocks and the other on cross-market forces. They push prices into and through support-resistance levels to test the waters and see how much volume is generated by their activity. Feedback loops then come into play, with a notable reversal when a specific level can’t be broken and a directional “pile-on” momentum when greed or fear triggers a breakout or breakdown.

Filter the ticker tape’s message through the most popular intraday technical tools. For example, the following extremes points to trend days

in which the tape reader needs to avoid swing reversal strategies because support and resistance levels are unlikely to hold.

- NYSE TICK probing greater than 1,000 or less than -1,000 repeatedly
- Advance/decline greater than 1,500 or less than -1,500 on both exchanges
- Advance/decline greater than 2,000 or less than -2,000 on one exchange
- Up/down volume in both exchanges greater than 4:1 or less than 1:4
- S&P 500 and Nasdaq-100 index futures up or down more than 2%

No two issues trade alike on the tape, so it's wise to observe ticker movement and check out certain risk characteristics before taking a position. Look for depth of participation and which players are spending the most time at the inside bid-ask. Measure volatility by comparing current price action against the width of a typical swing in a quiet market. Share size on the market depth screen is a total lie, due to rules that permit hidden orders, but the flow of buying and selling pressure might tell the truth, so average out total shares on one side of the market for several minutes and compare that number to relative price movement. This simple exercise could expose a few big whales swimming under the surface.

A QUICK CHECKLIST ON TAPE READING

1. **Memorize key levels on your favorite charts.** Then watch the tape whenever price approaches one of them. See if you can predict reversals before the crowd does.
2. **Look for divergences between sentiment and the tape flow.** Are hidden buyers holding up prices in the middle of a selloff, or do rallies fizzle out for no apparent reason?
3. **Ask if price action matches your expectations.** Look for buyers at breakout levels and sellers at breakdown levels. When they don't show up, stand aside or fade the trend.
4. **Use the opening price principle.** Draw a line across the opening tick on the S&P 500 and Nasdaq-100 using breakouts, breakdowns, and reversals as trading signals.

5. **Track the relationship between price and the daily range.** An instrument holding high in its daily range has hidden strength, while one hanging low has hidden weakness.
6. **Follow professionals in quiet times and the public in wild times.** Insiders chase volume during periods of conflict but lose control of the tape when the public enters the market.
7. **Liquid stocks move in channeled ranges.** Ignore oscillations in the middle of these zones, but focus undivided attention when prices reach upper or lower boundaries.
8. **Most volume comes from scalping machines pushing prices around for a few pennies.** Find the whales underneath these minnows to predict the next rally or selloff.

TAPE READING TELLS

Experienced tape readers keep a collection of key observations tucked away in their brains so they can act quickly whenever the tape cycles into analogous price action. This hodgepodge of personal signals, setups, and key tells can yield quick profits because the data come through personal experience instead of from reading a book or attending a seminar. Mr. Market plays a constant game of misdirection, but our accumulated tape knowledge lets us see through the veil and decipher key elements of the daily grind. Let's look at the most potent of these small portents of market direction:

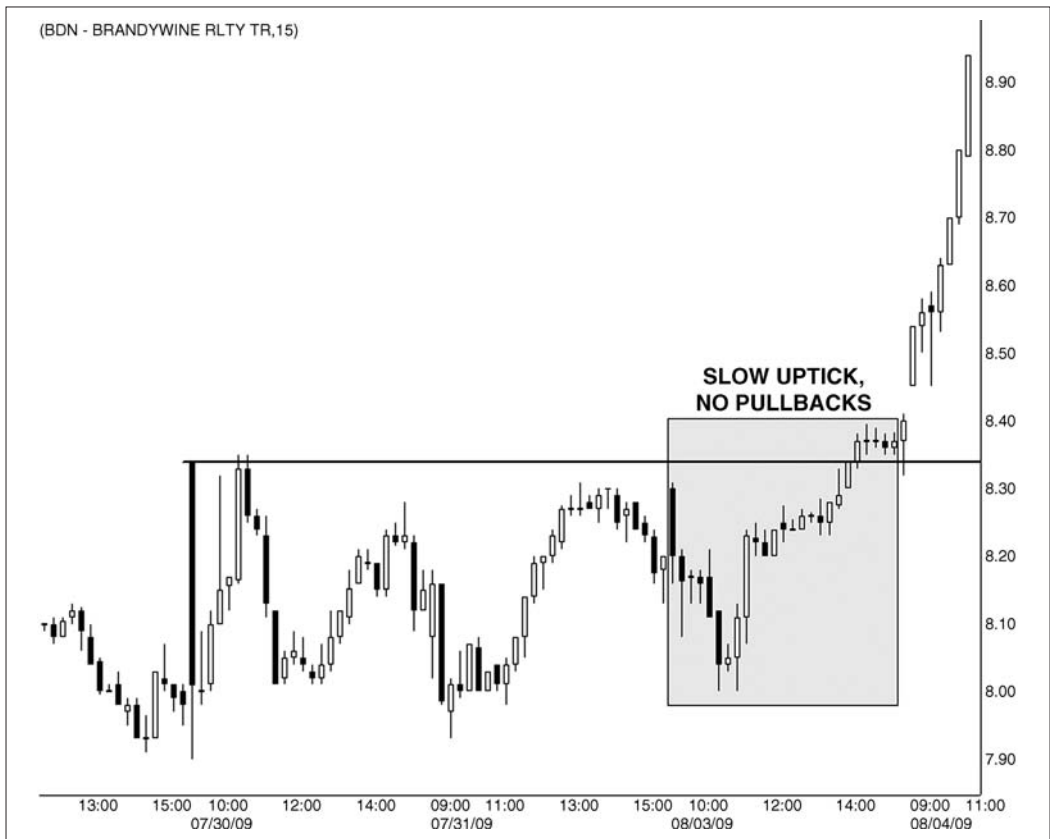
- **Globex futures.** Look at premarket index futures and see where they're trading relative to their day-session 15-minute 50-period moving averages. Expect a positive opening for stocks when index price sits on top of the average and a negative opening when it lies below. If the S&P 500 is above but the Nasdaq-100 is below, look for intraday rotation from tech and small caps, into the blue chips. Flip over this outlook when Nasdaq-100 is above and S&P 500 is below. On those days in particular, watch for speculative four letter stocks to take over the leadership mantle.
- **Advancers/decliners.** Market breadth and up/down volume offer valuable data on hidden strength or weakness. Buy midday pullbacks when breadth shows greater than 1,000 advancing to declining issues. Sell midday bounces when breadth shows less

than $-1,000$ advancing to declining issues. Up to down volume in both exchanges greater than 4:1 points to a trend day that favors the dominating side of the market. Assume there will be no intraday turnarounds when you see this type of price action. Instead, stop fighting the tape and focus intraday capital on 60-minute range breakouts or breakdowns that follow the prevailing trend.

- **Buy/sell flow.** The NYSE TICK exposes the peaks and valleys of intraday swing cycles. Look for large-scale reversals after

FIGURE 10.2

The experienced tape reader can decipher telltale action that's been overlooked by the crowd. For example, a slow creep rally into a resistance level that's held back price for three to five sessions is an early signal for a breakout. Brandywine Realty Trust spikes at 8.34 and pulls back. The stock reverses four times at that level in the next two days and then begins a slow and persistent uptick that gathers steam on the afternoon of August 3. Momentum escalates the next morning, triggering a vertical breakout.



the TICK hits an extreme reading, like plus or minus 1,400, for the third time in a single session. Use smaller TICK extremes to pinpoint intraday swings that will carry price the other way in a 60- to 90-minute cycle.

- **Stealth breakouts.** Watch for a breakout or breakdown when intraday price creeps toward a support or resistance level that it's failed to exceed multiple times in the last three to five sessions. This slow crawl will print a series of small bars with no pullbacks on the 15-minute chart. Look for these issues to hit the contested level and then expand quickly through the barrier.

Why does this type of price action predict a big rally or selloff? It's a common scenario in which big players have entered the market and are accumulating or dumping shares under the radar, trying not to attract attention. They push prices slowly by hitting the spread with small shares at regular intervals while supporting their positions with decent size on the other side of the market. Momentum eventually gathers steam, and the stock cuts through support or resistance like butter.

- **Historic price levels.** Stocks respond to every high or low on the chart, no matter how old or far away. Take profits and cut losses into big prints from prior years because they can easily stop a strong trend dead in its tracks. However, be patient because price often goes vertical into these magic numbers, yielding windfall gains. Highs and lows set into place five or ten years ago become excellent pivot points for new entries as well.
- **Algorithm games.** Stalk liquid stocks you want to buy on the pullback. Then watch as program algorithms take price down and down and down. Sit back and wait for the selloff to cut through short-term support. That happens because the eggheads writing these programs know the charts better than many traders and want to shake out poorly placed stops. Finally, wait for the bottom to drop out, and then look for the bid to stretch 20, 30, or 40 cents below the last print while the ask hardly moves. This predicts the selling frenzy is nearly over, and positions can be taken for a rebound. You now have to hit the asking price, even though it's much higher than the low printed by the falling bid.

Finally, here's an observation that will add considerable power to your tape reading expertise. Look for price action to cycle through three distinct phases when it moves into a key position just above resistance or just below support. Like so many elements of market dynamics, these

interrelated impulses track the action-reaction-resolution cycle, discussed in Chapter 2:

1. Euphoria driven by the breakout or breakdown
2. Fear triggered by a fade against the breakout or breakdown
3. Intensified euphoria or fear that confirms the breakout, breakdown, or pattern failure

Most traders focus their full attention on the excitement of the breakout or breakdown, jumping in when the ticker tape bursts with buying or selling activity. Of course, as I've argued throughout this text, this is a great way to lose money. In contrast, tape readers step back and examine the quality of this three-pronged conflict, which ultimately tells them whether the embryonic move is bona fide—or just a nasty trap waiting to be sprung.

PRE- AND POSTMARKET

The trading day doesn't begin at 9:30 a.m. New York time, nor does it end at 4:00 p.m. In our modern market environment, thousands of shares pass hands in the pre- and postmarkets, outside of routine business hours. Seriously, the trading game is hard enough when everyone else is doing it, so why get up early or stay late? The bottom line is, you'll make more money and take smaller losses if you play well through these extended sessions.

The pre- and postmarkets opened to the public during the height of the tech bubble. Prior to that, trading outside of the big exchanges was confined to Instinet, an exclusive club for Wall Street insiders. That exclusivity vanished forever when Island ECN offered the little guy a cheap way to keep on trading right into the dinner hour. Back then everyone believed the world markets were headed for 24-hour nirvana, where liquidity would follow sunrises around the globe. The 2000 to 2002 bear market crushed that pipe dream, with volume drying up to a trickle in the extended hours sessions. However, things changed once again with the advent of program algorithms, exchange mergers, and the growing dominance of Asian and European markets.

The extended hours offer a crazy quilt of opportunities in which you can buy and sell at amazing prices if you pay close attention to breaking news and shifting sentiment. This is especially true after one side gets

trapped because it failed to buy or sell ahead of the closing bell. The most obvious danger in pre- and postmarket trading comes from taking a position at the wrong price despite what *should* happen the next day. It's also risky because the illiquid environment usually translates into wide bid-ask spreads. This is a huge obstacle that warns us that, in many cases, it's better to just sit on our hands and wait for the regular session.

Traders have a tough time interpreting premarket news and its impact on the upcoming session, but the process of digesting early morning data isn't as hard as you might think. Start with a filtering mechanism that organizes news flow into its natural categories. Obviously, your initial focus must be on news that affects your open positions. Then look at upgrades, downgrades, and earnings reports because they'll all trigger volatile spikes, hurling prices well above or below closing prices. Fortunately, it isn't necessary to interpret these events in a vacuum because you can just watch and see how other market players respond to the information.

Upgrades and downgrades have a mixed impact on stocks, depending on market tone, seasonality, and price action leading into the bullish or bearish call. At a minimum, keep close tabs on ranking calls by the top tier houses. Simply stated, an event-triggered rally or selloff will last longer and move faster when Goldman Sachs upgrades Intel or downgrades Apple than would the same call coming from a Des Moines boutique. As a general rule, Monday analyst calls have the greatest impact because big houses use the start of the new week to move entire sectors rather than individual stocks. These broad brush opinions on popular sectors, like chip stocks or the financials, expose market segments where these folks have already positioned themselves and now want the public to pile in or pile out.

Avoid chasing premarket news, good or bad, into positions before or just after the opening bell. This is a weak-handed move that will likely be punished in the early part of the new trading day. A better strategy is to place the stock on a watch list and stand aside while it establishes a trading range though the first 45 minutes to two hours of the session. This morning range will contain most of the warm bodies that failed to sit on their hands when the news was first released. Stalk price movement while whipsaws punish these bag holders, and then use their pain to get on board at better entry levels. Just keep in mind it could be several days before the best trading opportunity comes along.

Take the time to catch up on overnight news in commodities and currencies to see how the rest of the world is trading. These are macro forces that could move broad equities when the U.S. markets finally

open. Hedge funds and Wall Street institutions often initiate their daily strategies through buying or selling in the overseas markets. With this in mind, focus on the reasons given for commodity or currency movement rather than trying to interpret fundamentals on the other side of the world. For example, you might find that primary attention is being drawn to an OPEC statement, a Fed pronouncement, or a Chinese growth forecast. It's likely the western financial media will latch onto these themes before the opening bell, forcing their impact on American traders whether they like it or not.

Understand the difference between premarket news and no news at all. Many companies flood the newswires with minor releases designed to move prices in their favor. These items often detail product sales or general activity that has little impact on operating results. Reporting outfits get tricked into publicizing these nonevents because they can't distinguish between market moving news and self-serving statements. The endless iPod and iPhone sales anecdotes, after those legendary products hit the market, fall into this nonproductive category. Finally, small cap biotech releases mark a special class of pre- and postmarket news. These companies lack revenues, so they depend on pipeline development to attract investors. In turn, the vast majority of biotech news involves study results rather than FDA approvals or rejections. As a result, it often takes just minutes for price action to discount the new data. This instant consumption can set up violent reversals at the open, with price losing part or all of its pre-market gains.

PLAYING THE PRE- AND POSTMARKETS

It takes time to learn the difference between hidden size in the extended hours and nervous amateurs making bad decisions. Here's an easy way to find out exactly who's taking the other side of the trade. Buy a little stock at the ask, even a hundred shares at a time, and see if your execution reduces the offer on the market depth screen. If it does, you just bought shares from a straightforward and possibly misinformed seller. Even better, your orders lift the market, with a healthy bidder stepping in and giving you a profitable exit if you need one. Alternatively, when the counterparty posts an even bigger offer to sell at the same price following your transaction, get out immediately and look for a different opportunity. In other words, you're simply attempting to trade with hidden size, and against the amateurs.

Take note where an active stock moves in the pre- and postmarkets, relative to obvious support or resistance levels. Specifically, does good news lift price above or into obvious resistance? Conversely, does bad news drop price through or into obvious support? A buying or selling spike that can't trade through a big level in the extended session is less likely to exceed it in the next regular session. Your observations in this regard will determine the best path of action for affected positions when the market finally opens. Generally speaking, favorable movement that stalls at support or resistance denotes an opportunity to take profits, but the same action against an open position tells us to hang tough, because a better exit price should show up later in the session.

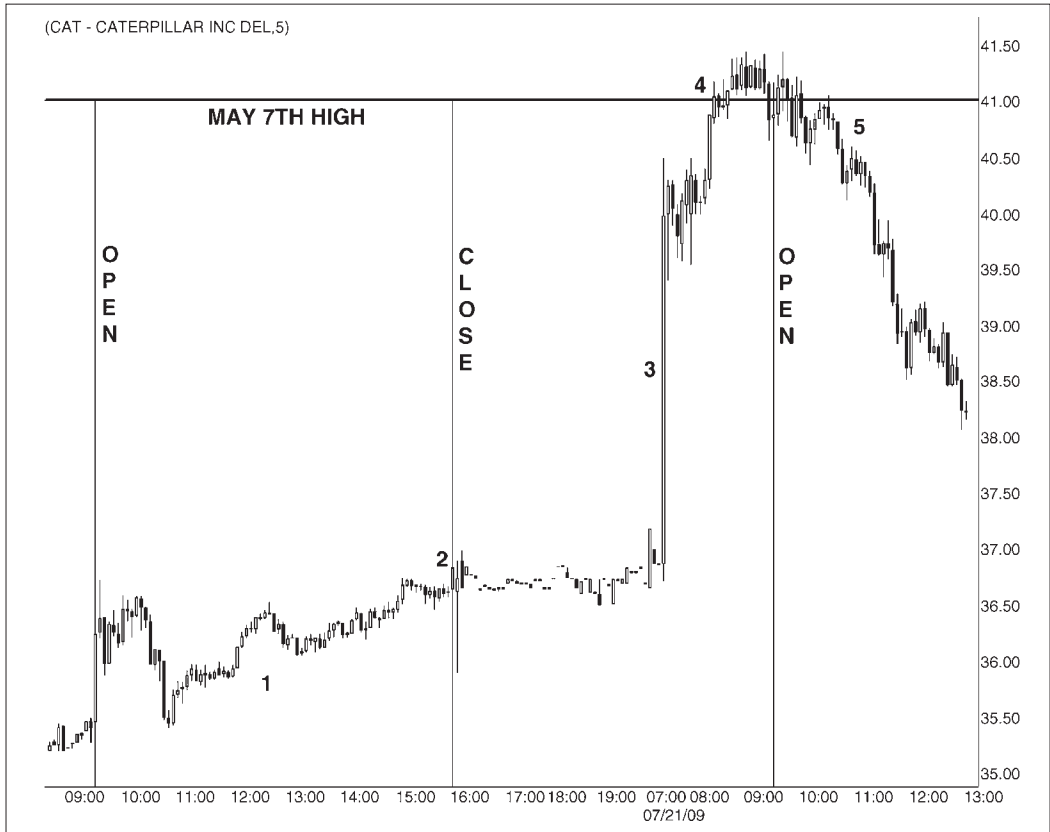
In Figure 10.3, the all-session chart shows interesting price progression ahead of and after Caterpillar earnings, released two hours before the New York open on July 21. The stock ticks higher for the entire day (1) ahead of the news in a typical speculative rally. It ends the session at high tick (2), with a gambling mentality lifting price into the closing bell. The premarket earnings release triggers a massive 5-minute bar (3) that lifts the stock more than three points. It grinds sideways for the next 45 minutes and then surges into the May 7 swing high at 41 (4), which marks the highest high before a two-month decline to 30. The rally stalls at 8:45 a.m., or 45 minutes prior to the open, right at May resistance. It grinds sideways just long enough to suck in overenthusiastic buyers at the opening bell and then sells off more than three points in the next three hours (5).

Fast fingers might have caught Caterpillar's premarket spike, but, realistically, the earnings news yielded few low-risk opportunities. Traders already positioned on the long side could have stalked the rally into resistance and taken profits without hesitation. The same barrier warned sidelined players to stand aside and avoid the open, because a fade to lower prices was likely. Contrary traders might have sold short into the buying spike, but the depth of the morning reversal was difficult to estimate, so the reward:risk profile was a toss-up.

Barron's is one of the few financial media outlets to publish over the weekend. It's Barron's style to pick and pan a variety of blue chip and high beta stocks which, in turn, could respond with a rally or selloff. For this reason, it makes sense to pull up these issues in Monday's premarket and see how the news is affecting them. This "Barron's Effect," if any, often persists through Monday's session, before a Tuesday reversal tosses cold water on the short-term trend. The main challenge lies in understanding whether or not their bullish or bearish outlook really matters. After all,

FIGURE 10.3

Caterpillar hits a ceiling.



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everyone has an opinion, and the impact of Saturday's proclamation is greatly reduced if it lacks tradable information.

How do you react when Barron's rips apart a stock you already own? Generally speaking, the worst thing you can do is to sell it into the premarket or that day's open. Instead, be patient, because there's often a tradable counterreaction by Tuesday or Wednesday. Admittedly, there's added risk in waiting, and you could still exit at an unfavorable price.

Use the premarket futures to establish your first spin on the trading day. Compare current prices to the prior close of the regular session at 4:15 p.m. New York time, and consider which side might get trapped at the

opening bell. This small-scale analysis can keep you out of a lot of trouble. Overnight action in the index futures vis-à-vis the prior day's close predicts direction with greater precision early in the week. For example, follow the trend when Monday's premarket leans in the same direction as Friday's close, but fade it when Tuesday's premarket tracks Monday's close. In theory at least, Turnaround Tuesday will reverse the trend sometime that morning.

Reaction to pre- and postmarket news surprises the most seasoned traders at times. Quite often, bad news in a rising market will be ignored, while good news during a correction triggers a selloff. This contrary behavior offers a valuable lesson for the survivalist trader. In reality, it doesn't matter whether the news is good or bad. Rather, we need to know how the fresh data are shaking up current expectations. This is a tough chore if you don't understand the concept of expectations in the first place, but it's extremely dangerous to trade without this insight because emotions and reactivity will guide position management rather than your powers of observation. At times, premarket news will shock the environment on a broad scale, placing one side at extreme risk. Take the morning of September 11, 2001, for example. For this reason, keep index futures and a few exchange-traded funds in a convenient spot on your broker interface at all times. Should the market suddenly pull hard in one direction in response to a major shock event, grab a few contracts or shares to hedge your portfolio. You'll find the biggest challenge in those chaotic moments is in matching the countertrades properly to current exposure.

If you take a passive approach to the market each morning, you set yourself up to get played by more aggressive traders. For this reason, it's vital to determine who has the upper hand as soon as possible each morning, and how aggressively you want to play the regular session when it finally begins. This premarket evaluation isn't set in stone, and you can turn it on a dime if the right data show up, but it's the most reliable strategy to get you through the opening bell.

PREMARKET CHECKLIST

Your premarket routine sets the stage for the rest of the trading day. Gathering actionable information and picking your fights carefully while your competition is still in dreamland can mean the difference between a profitable session and a losing nightmare. Traders have a tough time

interpreting the run-up into the opening bell, but it isn't as hard as it looks when you organize your efforts into key zones of market action:

1. **Check index futures.** Pull up the index futures and note current price levels. Then look at the overnight action, marking out the highs and lows posted through that period.
2. **Review macro forces.** Catch up on other world markets. Check out Asia and Europe to find out what moved their bourses while you were asleep. These hot spots establish key themes for American traders when things get cooking in the Big Apple.
3. **Filter the news flood.** Look first for news that might affect your positions. Then check out earning reports and broker rating changes.
4. **Watch other players.** Many broker interfaces let you follow transactions three to four hours prior to the New York open. Use this quiet time to observe how other players are dealing with big news or overnight shocks.
5. **Note levels.** Price levels that come into play in the premarket session can turn into swing highs and lows in the regular session. These reversal pivots hide big players trying to set boundaries or getting out of bad positions. Jot down those numbers and keep them close when the real action gets under way.
6. **Watch support-resistance.** Note where price moves in the premarket relative to support or resistance. Specifically, does good news send price above or into obvious resistance? Conversely, does bad news drop price through or into obvious support?
7. **Look for safe exits.** Early birds can find safe exits when shock events hit the market. The best escape route comes at 8:00 a.m. New York time when traders using discount brokers get their first quotes of the day. Post a pretty bid for them to execute before they realize that Armageddon has struck the tape.
8. **Establish a first bias.** Compare early action to the prior day's close, and think about who will get trapped and who will benefit from the imbalance. This analysis can help you avoid many weak-handed plays at the open.
9. **Respect seasonality.** Follow the trend when Monday's premarket leans in the same direction as Friday's close, but fade it when Tuesday's premarket tracks Monday's close. Look for continuation of the trend on Wednesday and Thursday, followed by a battle of opposing wills as the week draws to an end.

10. **Find the theme.** The majority of stocks won't do anything that day, so it's your job to uncover the handful of issues ready to move. Triage the list by watching premarket volume because it shows where other traders are risking their money.
11. **Think irrationally.** It doesn't matter if premarket news is good or bad. More importantly, how does it shake up expectations? If you can't figure this out for yourself, find experts you trust and listen to them.
12. **Place deep limit orders.** Place limit orders in the premarket at prices where no one in their right mind will give you the bargain of the century. Then sit back and watch these gifts get filled because other traders panic or just haven't woken up yet.
13. **Set your collar.** Determine who has the upper hand and how aggressive you want to trade after the market opens for business.
14. **Avoid the crowd.** Compile a list of early morning momentum plays and then sit on your hands, waiting until the reactionary crowd gets trapped on the wrong side of the tape.
15. **Cover dips and sell spikes.** Speculative stocks jump big percentages in the premarket when they report simple news items. These spikes often print the highs or lows of the day, so use them to take profits and wait for reentry at better prices.

TRADING THE NEWS

News events generally fall into one of three categories: economic, company, or institutional releases. Economic releases are scheduled well in advance, with most of them hitting the airwaves at 8:30 a.m., 9:45 a.m., or 10:00 a.m. New York time. Company releases can come at any time but surge in the weeks following the end of a quarter. Institutional releases tend to spike on Monday mornings but continue throughout the week. Of the three categories, traders get economic news with the shortest delay from source to media release. Earnings reports come in second because SEC rules force companies to distribute quarterly results through a wide variety of sources at the same time. Institutional releases are the slowest of the three by a wide margin. In fact, traders should assume that preferred clients have already acted upon analyst upgrades and downgrades by the time that type of news is released to the public.

Traders face a huge challenge trying to decipher cause-and-effect relationships between news and price movement. They'll often assume that good news is good and buy a stock that's risen for a few days, not realizing that smart money has already bought the rumor and is getting ready to sell the news. In most cases, fast-moving algorithms will squeeze out a stock's initial news-driven inefficiency by the time you read it or hear about it. You can see this happening in the Caterpillar spike posted earlier in this chapter.

So how can the survivalist trader take advantage of news-related opportunities without becoming the market's ultimate bag holder? Start by standing aside through most news items or exiting positions just minutes before scheduled news hits the airwaves. Instead, save your firepower for shock events that fall well outside current expectations. The best entry into postnews volatility often comes on the afternoon following the release, or even two to three days later.

Here's the theory: Everyone who wants to buy or sell the news takes a position within the first few hours after it hits the wires. Once they've charged off the sidelines, there's no one left to take that side of the market, which immediately triggers a buy-sell imbalance. In turn, this forces a reversal or shakeout, which is your cue to wake up and get to work. Pull up a 60-minute chart and pick out the most obvious support-resistance levels. Assume the reversal will eventually reach the 50-period EMA before there's a major counterswing. Place tiered limit orders and enter the trade in small pieces, so you'll be positioned if price turns ahead of schedule. Once you've loaded up, be prepared to hold the trade at a loss until the primary trend reasserts itself or your stop gets hit.

More conservative traders can stand aside even longer when there's a sharp pullback after a news-driven rally. Be patient during the retracement process, and wait for a low-risk entry to set up and yield a buy signal. For example, selling pressure will often end with a breakout in a lower time frame pattern, like a 60-minute bull flag. Note that although you're assuming risk a few days after the big news event, the intraday chart is generating the majority of feedback needed to compute the reward:risk profile and to find your entry price. Once positioned, focus your undivided attention on the highs of the news day and exit the position immediately if a double top pattern starts to form.

These news entry techniques will give you enough courage to jump in the next time your favorite company blows away earnings expectations or announces the next iGadget, but what about economic releases that move the world markets each day? Start with a close look at the market

FIGURE 10.4

News that shocks expectations can trigger buy-sell imbalances that take several days to unwind. Amgen releases data showing the superiority of its cancer drug over a competing product. The stock gaps nine points and then sells off in a steady downtick for nearly four days, relieving the short-term overbought condition. The stock tags the 50-bar EMA and settles into a series of higher lows that traders can use to enter positions ahead of a breakout into the mid-sixties.



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clock. Many government reports, including monthly unemployment numbers, get released one hour before the New York opening bell. It's vital that traders be wide awake and glued to their screens when these items hit the newswires. Even better, watch the index futures for an hour or so before the release, and identify any bias that will get supported or faded depending on the news.

Don't trade the economic release directly. Instead, watch the index futures after the news and take note of price boundaries getting hit in the next few minutes. The key observation is similar to earning news, i.e., whether prices trade into or through obvious support-resistance levels. Trading into a major line in the sand suggests the broad market will reverse shortly after the open. Trading through a major barrier generates a testing phase that might yield a trend day in the first hour of the regular session.

The strongest trend days come when there's synergy between pre-release bias and subsequent news. The major indices can gap 2% or more and hold the opening price easily when these two forces are in sync. Conversely, watch out for a shakeout day when a major report, like the monthly labor numbers, gives neither side an obvious advantage. Fortunately, those choppy sessions often present opportunities to build multi-day positions. Identify your entry levels early, and then step in slowly as the shakeout unfolds and pulls the market toward your trigger numbers. Then hold on tight and look for follow-through in the next one to three days.

Just stick to the charts and play the technicals. When you second-guess yourself because a release "looks" bullish or bearish, you'll hesitate just as the best trade is being offered to you. The bottom line is, we're not smart enough to understand the news or what it suggests about the economic outlook, but we can see how everyone else is interpreting it and then take appropriate action. Also keep in mind that you're a trader and not a gambler. Never buy or sell before an economic number just to play the release. These are lottery tickets that have no place in a sound trading strategy. It's even worse if you make money a few times on such gambles, because the horse race mentality sets you up for massive failure down the road.

The ticker tape often gets painted into economic numbers and then faded after the actual releases. Beneath the surface, big money is using the news to find better prices to sell short or to shake the public out of long positions. You can often predict these infuriating reversals through convergence-divergence relationships. Consider where the market closed in the prior session and what the sentiment bias was at that time. For example, a selloff day closes near the daily lows. You wake up the next morning, expecting a red screen and a big gap down. To your surprise, the index futures are trading a few ticks or points higher in a persistent bid. Then you recall there's a big economic release coming out at 10:00 a.m. The weak rally continues into the report, and the market then sells off violently on relatively good news. As it turns out, a false bid was propping up

the index futures so big money could sell short at higher prices. Sadly, this is business as usual with economic reports that public traders believe are market movers, while funds and institutions view the same data as old, flawed, or inconsequential.

Finally, watch out for economic numbers that fall well outside standard deviation. All bets are off when the market spits out one of these rarities. The good news is that you're on equal footing with the big boys when this happens, because they're just as surprised as everyone else.

INTRADAY BUY-SELL SWING

The vast majority of stocks follow the direction of the intraday swing, although each issue moving in lockstep will be relatively stronger or weaker than the broader averages. This forces the survivalist trader to complete two critical tasks. First, find instruments that take advantage of the intraday swing in that particular session. Second, find the best times of day to enter and exit the market. A little common sense goes a long way here. For example, it's logical to play the strongest stocks we can find during the opening hour of an up day. Remarkably, we often do the exact opposite because we overthink the process and forget to use our eyeballs. Here's a better plan. Just look at your trading screen after the index futures set up a potential rally day, and trade the issues glowing the brightest shade of green. After all, they're attracting the most capital, in response to the initial rally impulse.

However, tactics need to evolve after the first 60 minutes because a strong stock tends to move higher early in the session and then pull back through the midday hours. These issues routinely attract a second wave of buying interest later in the day or the next morning and resume their uptrends. So, rather than chasing a strong stock after the first hour, sit back and wait for the contrary trade to develop. This often happens as soon as the pullback drops just below the price level it shouldn't reach on a purely technical basis. This mini-failure shakes out the last set of stops and invites weak-handed short sellers looking for a fast buck. Their impatience adds just enough upside fuel to lift the stock back above the broken level and to establish a new upswing.

As I noted in the first chapter, index futures oscillation generates the rhythmic pulse that defines the intraday swing. In the real world, however, interpreting the swing requires more brainpower than just staring at a simple uptrend or downtrend. Perhaps that's why the opening price

FIGURE 10.5

Strong openings often give way to midday shakeouts. Joy Global spikes up to a new swing high four mornings in a row. The stock prints the intraday high in the first 90 minutes of each session and spends the rest of the day churning through the early range. The momentum crowd chasing the first hour uptrend got shaken and stirred, while the survivalist trader bought weakness and sold the next day's open for a healthy profit. Note how broken swing lows in the first three sessions (1, 2, 3) printed contrary buy signals.



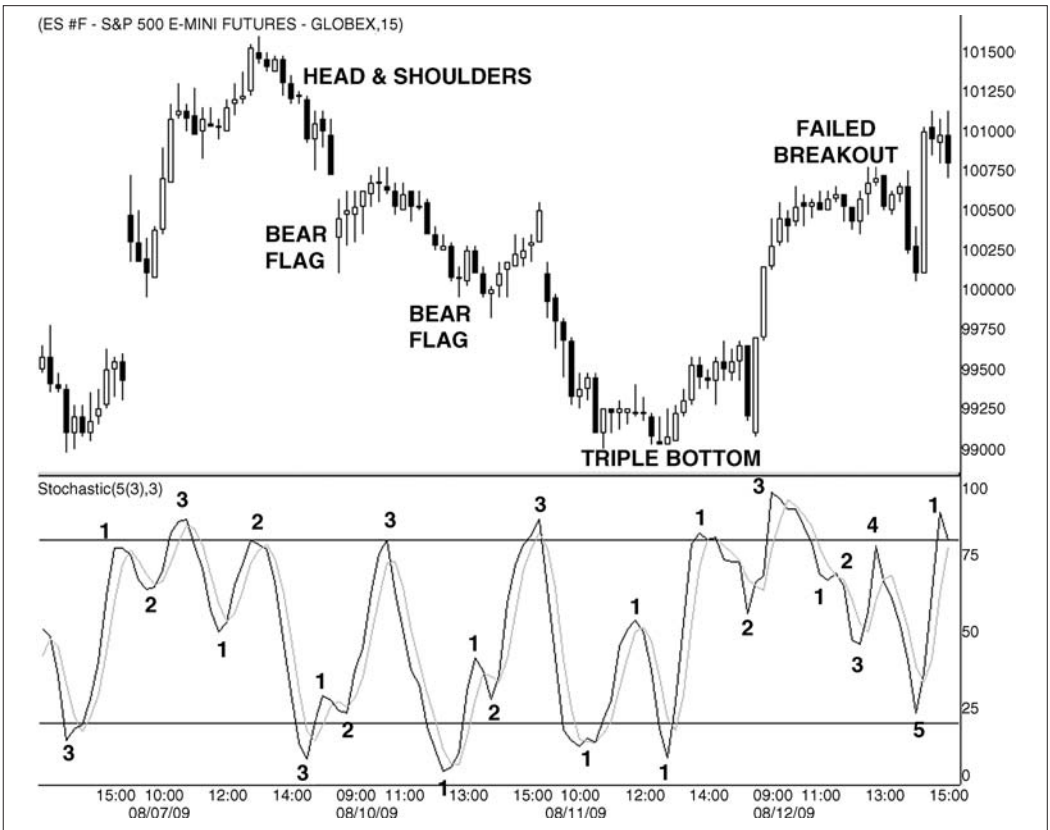
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principle and first hour trading range have become staples of intraday market analysis. The utility of these technical tools is simple enough to understand. Market players start the new session looking for “tells” that expose relative levels of buying and selling pressure. The opening print yields an immediate testing level, while the early trading range provides two more data points within the first 60 minutes. Together, these three levels set up logical proving grounds for the short-term trend.

On positive days, the index futures use first hour breakouts and pullbacks to opening prices as springboards for substantial rallies. Flip this over for selloff days. More often than not, conflicted sessions trigger whipsaws that render these levels useless for the day. That's why it so important to watch for wide range bars triggered by these inflection points. Simply stated, when a moving market expands sharply away from a first hour high, first hour low, or the opening print, those levels become trigger points for trading decisions later in the day or even in the following session. Interplay between price action and these pivot points can be complex, contrary, or hard to interpret at times. For example, a significant downside swing often evolves after the index futures break above the first hour range, chop around for a few minutes, and then fall

FIGURE 10.6

S&P 500 intraday swings.



back within its boundaries. This small-scale pattern failure encourages traders to close out long positions, establish short sales, and pile in with downside momentum strategies. This contrary phenomenon also follows a diabolical quirk in which *real* selloffs don't start until the index futures break out, while *real* rallies don't start until they break down.

A well-tuned 15-minute Stochastics (Figure 10.6) lets traders visualize the intraday swing with great ease, but proper interpretation is everything with this classic tool. For starters, don't assume a reversal is coming just because the indicator hits overbought or oversold territory. Instead, wait for confirmation in the price pattern or for the indicator to accelerate in the opposite direction. Once a new swing begins, look for a 1-2-3 or 1-2-3-4-5 pattern before the start of the next counterswing. Remain skeptical and on the sidelines when the indicator surges toward the halfway point between overbought and oversold levels and then turns in the opposite direction. More often than not, this is a false positive designed to trap overeager traders.

Four days of S&P 500 index futures oscillation point out the value of Stochastics cycle analysis. The instrument pivots through repeated 1-2-3 impulses with a few aborted swings and a single 1-2-3-4-5 swing. Each oscillation establishes a convergence-divergence relationship with relative price movement, not absolute price movement. In other words, it doesn't tell us whether the swing is taking place near a price high or low. However, it does help the trader to interpret classic technical patterns developing in the intraday market. For example, Stochastics downswings confirm sell signals for the August 7 head and shoulders pattern, as well as two bear flag breakdowns. In addition, the failed breakout on August 12 unfolds while the 1-2-3-4-5 downswing diverges sharply with the rising index.

GAP STRATEGIES

Gaps are shock events that jolt price up or down, leaving an open window to the last bar. Chapter 5 of *The Master Swing Trader* presents a detailed background on this elemental charting phenomenon. Market folklore offers guidance on trading gaps, but statements like "gaps get filled" don't tell us how to make the right decisions when one suddenly appears on the price chart. So, how can we take advantage of a gap when sitting on the sidelines, and how do we protect ourselves when caught on the wrong side of a big hole at the opening bell?

First, we need to figure out what kind of gap we're actually dealing with. Certain trades work best with each gap type, so proper identification is extremely important. In most cases, gaps will fall into one of these three groupings, based on relative location:

- Breakaway gaps appear as markets break out into new trends, up or down.
- Continuation gaps print about halfway through trends, when enthusiasm or fear overpowers reason.
- Exhaustion gaps burn out trends with one last surge of emotion and price movement.

Generally speaking, gaps also fall into one of three *emotional* categories:

- Breakaway gaps *surprise* because they appear suddenly on charts you've ignored.
- Continuation gaps *exhilarate* because they pay off big as momentum accelerates.
- Exhaustion gaps *frustrate* because they turn up when your analysis points to a reversal.

Breakaway gaps trigger momentum dynamics, which often yield immediate follow-through in the direction of the new trend. These fast-moving markets can be difficult to enter, especially for the survivalist trader. Two strategies work in specific scenarios, but many of these volatile gaps are best left to the momentum crowd, at least until a counterswing sets into motion. The first technique is simple enough: wait for a postgap range to develop, and trade the breakout in the direction of the new trend.

The second strategy revolves around the classic pullback play. The counterswing after a breakaway gap favors a reversal back in the direction of the primary trend, even if the holes get filled marginally. For this reason, it makes sense to buy a low volume decline after a notable breakout, or to sell the low volume bounce after a notable breakdown. The countertrend will often carve out a flag pattern that retraces 50% or less of the trend wave that includes the gap. Enter right at the gap fill if the counterwave reaches that far, or wait for a flag breakout or breakdown. The trick is to get positioned early in the reversal because the primary trend, once reactivated, should carry well above the breakout high or below the selloff low.

FIGURE 10.7

Sell the pullback to a downside breakaway gap in anticipation of a continued decline. ANADIGICS ticks higher for nearly three months and then breaks the bullish trendline (1) in a huge breakaway gap. The selloff carries to 13.75 and gives way to a bear flag bounce (2) that fails under the 38% retracement, near the high of the gap bar. The flag breakdown triggers a reliable sell signal for a continued downtrend that takes out the first low (3).



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Markets often retest breakaway gaps right after they occur, but many bars can pass before price returns to test a continuation gap. Also, you can't trade a continuation gap if you can't find it, so here's an old technician's trick: Wait until you can count three distinct trend waves, up or down. Then measure out the rally or selloff from start to finish, and look for a gap around the 50% level. Realistically, the gap doesn't need to be perfectly positioned as long as it fits with the three-wave observation.

Once you've located the continuation gap, wait for price to pull into a test and place a limit order within its boundaries. The retracement, or move against the primary trend, should run into a brick wall in the vicinity of the gap and reverse sharply. Realistically, the continuation gap may fill for a few bars before the trend reverses. With this in mind, a more defensive strategy is to stand aside until the instrument enters the gap and then moves forcefully in the other direction, before entering the

FIGURE 10.8

Exhaustion gaps can set up profitable short sales. ATP Oil & Gas doubles in price in less than two weeks. The uptrend accelerates on May 7 with a massive gap that fills in the first hour of the session. The parabolic rise and subsequent failure point to an exhaustion gap that will end the trend. The trader can enter the short sale on a bounce into the last swing high, prior to the gap (1), or wait for a notable reversal, like the May 11 down gap (2), and then sell short.



position. You'll find an illustration of this classic continuation gap strategy in Chapter 1.

Watch from the sidelines when an exhaustion gap makes its unexpected appearance following an extended rally or selloff, and enter a trade in the opposite direction of the trend in place prior to the gap. These final impulses often take on a parabolic look, with a subsequent reversal at the same angle of attack as the primary trend. These big holes, once filled, often mark the end of uptrends or downtrends, with the last burst of energy signaling a climax ahead of a major counterswing. In addition, exhaustion gaps give already-positioned traders opportunistic signals to take long side profits or to cover short sales.

Apply a little common sense when observing premarket action above or below the last closing price. The most important question for the survivalist trader: does the news or ticker tape justify the gap you're going to see when the opening bell finally rings? Overemotional traders put out market orders before the open to get into gap plays, trying to catch a ride on the momentum train. Unfortunately, this reactionary practice often yields the worst fills imaginable. A better plan is to stand aside at the open and apply a first hour range breakout/breakdown strategy. However, gaps trigger unique pattern features that must be custom fitted with this broad approach. You'll find a detailed examination of these entry techniques in the last section of this chapter.

RINSE JOBS

The rinse job denotes a sudden dislocation during a rangebound phase in which price thrusts above or below support-resistance and then reverses, closing back within the boundaries of the sideways pattern. These buying or selling spikes shake out stop losses and trigger all sorts of contrary entry signals. Rinse jobs can unfold in many ways, but two manifestations are most common in our modern diabolical markets:

- **Bull or bear trap.** The instrument gaps out of a 15-minute or 60-minute range at the opening bell, draws in breakout or breakdown traders, and then reverses hard, filling the gap.
- **Stop-gunning exercise.** The instrument grinds sideways for a few hours, attracting the continuation trade. Price suddenly jumps out of the quiet range, thrusts a few ticks, and then reverses hard.

Trapping behavior is most common in the latter phases of established trends, in which one side is controlling the tape. As a rule, complacency runs high in long uptrends, setting up abnormally low put/call readings. Flip over this tendency in long downtrends when chronic fear yields equally high put/call readings. Both scenarios present ideal conditions for gaps against the prevailing trend that shake out weak hands and reestablish a balance between positive and negative sentiment. In most cases, these gaps fill quickly and the trend resumes until the next imbalance yields another trap.

Traps are also set when one side of the market gets overcrowded because a large-scale news shock is so bullish or bearish that traders overreact and chase one strategy too aggressively. The capture of Saddam Hussein in 2003 and the London bombing in 2005 both yielded this type of extreme reaction, with massive gaps that filled immediately, trapping bulls after the first event and bears after the second event. These contrary dynamics play out all the time, to a lesser degree, after economic or earnings releases that shock the prevailing wisdom.

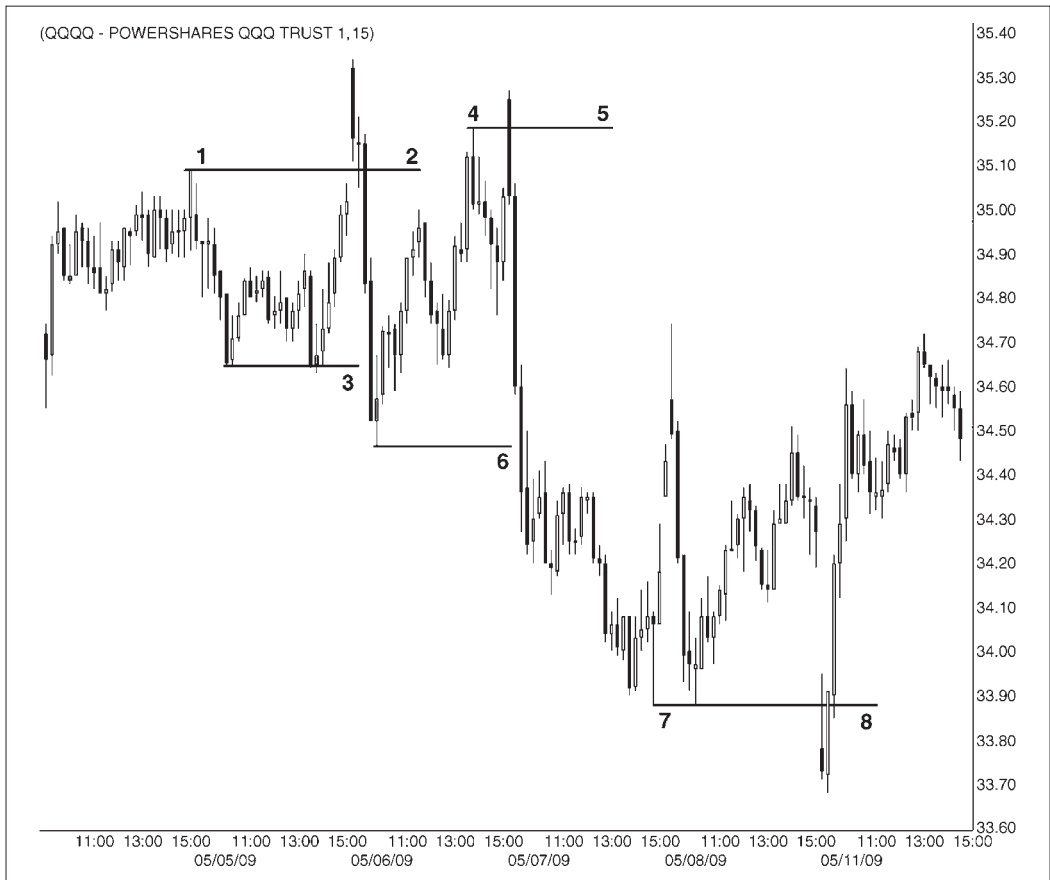
In Figure 10.9, the Nasdaq-100 Trust (previously the Powershares QQQ Trust) closes at the high tick (1) on May 4 and pulls back the following day. It closes just under the high and breaks out on May 6 in a healthy gap. Sellers enter the market immediately, knocking the fund back under the two-day high (2) in a rinse job that yields a vertical selloff. The decline breaks the low of the prior day (3) and then recovers strongly, closing about 35 cents under the opening high. The trust gaps above the prior day's recovery high (4) the next morning and sells off (5) in yet another rinse job. This decline also breaks the low of the prior day (6). Price tests the multiday low (7) in the next session and closes strongly. A third rinse job erupts the following morning, with a down gap (8) that undercuts the multiday low and then zooms higher, trapping early short sellers.

Overnight rinse jobs, especially on the major indices, get most of our attention, but midday events are also common, especially in dull or sideways markets. These rinse jobs take on two distinct scenarios.

- A morning trend reverses and pulls into a common support or resistance level. Pullback traders jump in, and price cuts sharply through that level, shaking out those orders. The instrument then reverses and reestablishes the early trend.
- A trading range, lasting days or weeks, is broken suddenly by a vertical rally or selloff triggering a variety of entry and exit signals. Price takes in these orders and then reverses, closing the session back within the daily or weekly range.

FIGURE 10.9

Three Nasdaq-100 Trust rinse jobs.



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The first scenario tracks the Joy Global example referenced earlier in this chapter. This manifestation has great predictive value when it occurs on the index futures because intraday equity positions are likely to reverse in lockstep behavior. In addition, these small patterns yield instant trade setups because we can place stops just outside the buying or selling spike and capture a low-risk entry into the morning trend. Once positioned, price should “snap back” through support-resistance by the close of the next 15-minute bar. If it holds the new high or low any longer than that, the countertrend can attract momentum players and yield a secondary spike that cuts through the stop loss.

FIGURE 10.10

Rinse jobs often unfold when price tests a rangebound high or low. Cavium Networks sets up a trading range (1, 2) between 16 and 17.50. The stock sells off toward range support on July 7 and closes (3) near 16.30. It breaks down in the first hour of the following session, dropping 50 cents and then shooting higher (4), closing above 16 in a daily-scale bull hammer reversal. Price continues higher for the next three sessions and then breaks out strongly (5).



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You might not locate second scenario events until they show up in your end-of-day research. You can find these patterns with the 7-Bells Finger Finder scan, outlined in *The Master Swing Trader*, because they'll often print daily-scale hammer or doji candlesticks. This rinse job generates ideal conditions for the instrument to trend sharply out of the opposite side of the trading range because the event cleans out one side of the supply-demand equation, setting up an imbalance between buyers and sellers. It then takes just a little pressure in that direction to have a

magnified effect on price movement. No, it isn't a pleasant experience if you're caught holding the bag during these rinse job reversals, but it does mark a great opportunity if you're coming off the sidelines. Just keep in mind that the market dynamics triggered by these events are time sensitive. Realistically, the buy-sell imbalance will persist for just three to five sessions before new money comes in and equalizes the equation.

Rinse jobs can evolve over a few days, rather than showing perfect alignment with a single intraday session. In a classic example, a stock sells off for several days, finally reaching a major support level, like the 50-day EMA. It breaks down in the following session and closes poorly. Price then pops back above support and traps late sellers, or hovers just under the moving average for up to a week and then shoots higher, having the same effect over a longer time period. In both cases, rinse job mechanics have worked perfectly to shake out weak hands and set up a notable reversal.

EVENT RISK

Traders can study the price patterns and read all the latest news but still get burned by event risk, so we need to incorporate this negative influence into our performance expectations. What exactly is event risk? It refers to unexpected developments that adversely impact our positions. It's a chaos factor that can be stock specific, like a major downgrade, or a worldwide shock like Hurricane Katrina or September 11. Stock specific event risk usually arrives through one of three potent sources:

- Financial institutions shock expectations with upgrades, downgrades, and changed price targets.
- Companies hit the newswires with preannouncements, warnings, secondary offerings, and executive departures.
- Governments impact confidence with FDA approvals and rejections, SEC investigations and rules, and congressional mandates.

A few years ago, only tier one brokers had a significant effect on short-term price action, but that's no longer the case as the smallest boutique firm can now trigger a rally or selloff, if the timing is right, because hedge funds will jump on and pile into all opportunistic targets. The greatest downgrade threat comes after a stock gets stretched to the upside

because traders are nervous nellys, with paranoia increasing exponentially with each uptick. Meanwhile, salivating short sellers look at the downgrade as a perfect opportunity to trap complacent buyers and turn the stock around.

Biotechs attract additional layers of event risk. The Food and Drug Administration approves and rejects drug applications all the time. While major announcements are telegraphed in advance, most decisions come with no warning at all. Drug regulators also release a variety of secondary judgments regarding use, marketing claims, and warning labels. All of these news items have the power to turn a quiet morning into a living nightmare. Of course, direct release of research data into the premarket session will have a similar effect on the tape. Fortunately, the companies control information flow on these studies and do their best to contain event risk. After all, it's tough to get funding when your drugs or research don't help sick people.

Traders must incorporate event risk into their assumptions about profitability. For starters, expect to get caught in nasty surprises at least three to four times per year, losing a substantial amount of money each time it happens. Integrate those generous loss numbers into your annual performance expectations. Accepting event risk in advance reduces shock value when it happens and lets you mitigate its considerable impact to your bottom line. Whatever you do, don't panic and dump your affected positions at the worst possible prices. Instead, have a clearly outlined escape plan ready to go, and exercise it with emotional detachment.

Shock events triggered in the premarket hours give observant traders a clearly defined edge, using the strategies outlined earlier in this chapter. These might be sufficient to ease the pain, but there are other mitigation techniques available when an early exit isn't an option. Start with an examination of the affected stock's premarket range, assuming that big players have already defined support and resistance levels. Then wait for a counterreaction after the market opens, and dump your position into this swing, if possible. Does this technique work all of the time? No, but you'll see a variation on this theme quite often because legions of weak-handed players come pouring into the market in reaction to news shocks. This overcrowding activity triggers a short-term imbalance, targeting these folks for pain.

Event risk warns traders and investors that our pockets can get picked at any time. It also exposes the dividing line between position management and pure chaos. Like card players, we're vulnerable to the luck of the draw

even though we're managing our hands with great skill. Curiously, event shock often signals the opening round of a drawdown phase that can last for weeks. This might occur because the loss triggers negative psychological characteristics that undermine performance beyond the initial event. So, if you're feeling emotionally "spent" after event risk beats you up, the right response is to walk away before doing further damage.

A wise man once said, we should change those things that can be changed but accept those things that cannot. This ancient advice goes a long way toward minimizing our exposure to event risk. It tells us to accept the nature of risk and to take protective measures to avoid getting clobbered by the unexpected. Not surprisingly, most shock losses come after we ignore a number of warning signs. Regrettably, we can spend hours flipping through charts but pay no attention at all to multiple red flags after pulling the trigger.

In many cases, there are no warnings, but the stock gets clobbered anyway. Our comfort lies in knowing it didn't happen because of poor trading skills or ineffective trade management. All we can do when stuck in this whirlwind is to initiate our fire drill, lick our wounds, and make the next trade the best one we've ever had.

THE CHOPPING BLOCK

Making money is easy in easy markets, but can you keep it when everything stops trending and just chops sideways for weeks or months? Unfortunately, the majority of folks that make money in hot markets lose every dime as soon as the tape goes ice cold. This is just a fact of life. On the other hand, the survivalist trader heeds the warning signs of a dead market and takes steps to preserve equity until the low-hanging fruit shows up once again. We all know how good it feels when the green ink grows greener, but big dollar signs trigger bouts of amnesia throughout the trading community. In particular, traders believe their growing equity curve is a function of their brilliance or savvy, as opposed to the real reason they made money—they got lucky riding the trend wave.

This popular illusion is commonly referred to as bull market genius. Long-sided momentum markets foster this delusional mindset and cultivate it to the point where its many disciples are set up for the perfect storm of failure. Reality comes as a complete shock to these individuals

because they weren't playing a legitimate hand in the first place. Fortunately, there's no need to panic if this sounds like you because lousy markets also generate ideal conditions for trading brilliance. In other words, the market's laziest lemmings have an opportunity to discover career-sustaining strategies instead of crashing to earth when the majority gets the wind sucked out of their sails.

It's an absolute certainty that momentum markets will die out and force you to address major flaws that have hurt you in the past. It's just as certain the uptrend or downtrend that made you a fortune will give way to months of conflicted action that test your resilience, profitability, and sanity. So stop wasting your time and start working on the significant changes needed to make money in all types of markets. Start this transformation by ditching the gunslinger attitude as soon as choppy action takes control of the tape. In reality, you're just a guy or gal who finally stopped losing money because the market was giving away a few decent gifts. Now you need to avoid the failure cycle you've suffered every other time you turned a profit. This is hard work that will demand your deep humility and an absolute focus on market conditions. It's also time for you to shut up, shift gears, and become a humble student once again, listening intently to the new lessons the market is trying to teach you.

Choppy periods rob profits through overtrading, formfitting, and generalized boredom. The most valuable skill that traders can exercise during these shakeouts is to sit on their hands and do nothing. Of course, that's easier said than done because our peculiar species is hardwired toward action rather than inaction. Crowd dynamics shift violently when the chopping block is alive and well, with the public withdrawing from the market and leaving behind a barren landscape that pits professional against professional. At-home traders have an especially tough time making money when these goliaths are butting heads because support and resistance levels become points of ambush rather than opportunities to buy or sell. Action-reaction-resolution dynamics go awry as well during these unpleasant periods. In better times, a financial instrument will break out to a high or low, pull back to test support or resistance, and then surge through the high or low, confirming the trend. However, when the chopping block is active, the initial break (action) proceeds as normal, but the test (reaction) devolves into a chaotic mess that shakes out momentum and pullback positions. The third phase (resolution) finally arrives, confirming a breakout or triggering a failure, but it doesn't matter any more because there's no one left standing to make any money.

Take precautions as soon as you recognize the onset of a chopping block. Reduce holding period and avoid overnight positions because reversals can trigger on a daily basis. This is called red bar–green bar syndrome, which is self-explanatory. It’s funny, because day traders get soundly criticized in the financial media but still practice one of the most effective strategies in a choppy market. Of course, many of us don’t have the time or disposition to trade in this manner, but we can still use a day trader’s frenetic mindset to our advantage. Above all else, keep an itchy finger on the exit button, and don’t wait for an invitation to get out of a losing trade.

Another way to deal with choppy markets is to find low-priced stocks that have avoided the maelstrom. Cheap stocks are risky but often trade better than blue chips during these periods because retail players dominate the price action. This crowd also has less to hide than a typical hedge fund or institution, so trends are often more reliable. However, when playing small stocks in a choppy market, avoid the best-known names and go with issues that are under the radar because they’ll attract less unwelcome attention. In turn, this filtering should yield more consistent price behavior.

Almost every gap gets filled and reversed in the chopping block, so use this common tendency to your advantage, following the gap regimen outlined at the end of this chapter. If you’re the type of trader who gets a tummy ache when looking at a gap right after the open, sit on your hands, take a deep breath, and let other traders take the bait first. Then, if the price action follows your expectations, go ahead and get your feet wet. Conversely, gaps holding their prices and surging into trends are major signals that a chopping block environment is giving way to a better market.

Conflict and indifference characterize choppy markets, forcing traders to outwit each other with contrary strategies and time frames. These perverse tactics include fading breakouts, reversing overnight momentum, and defying common wisdom on things like gaps and trendlines. Simply stated, the chopping block will drive you crazy if you think technical analysis is gospel because a major goal during these periods is to hurt traders who bury their noses too deeply in the patterns and indicators. Ironically, the traps and whipsaws prove the value of technical analysis rather than undermining it, because they admonish us to forget common definitions when we look at the charts and just trade contested levels in whatever way screws the majority.

There are just a limited number of ways to profit in the tortuous chopping block. First, trade at the edges of the block, after endless games

shake out everyone else. Second, play the fading game as well as your competition. Take a giant step back, review the examples in this book, and learn to see traps before they're set. If you look closely enough, you'll notice how the tape draws pretty pictures through sentiment and price action. Then, just like a military strategist, scan the landscape for the most advantageous ambush points, and spring your trap as soon as the majority believes the illusion and jumps into the market.

Does this contrary thinking sound like a lot of work just to make a few bucks? Well, yes and no. While it requires a different skill set than typical bull or bear market genius, it's the only way to survive and prosper when playing in the big leagues.

THE REAL WORLD: RIDING THE TIGER

The market gaps up at the open and breaks out. You're sitting on the sidelines and want to get into the action but don't know where or when to buy.

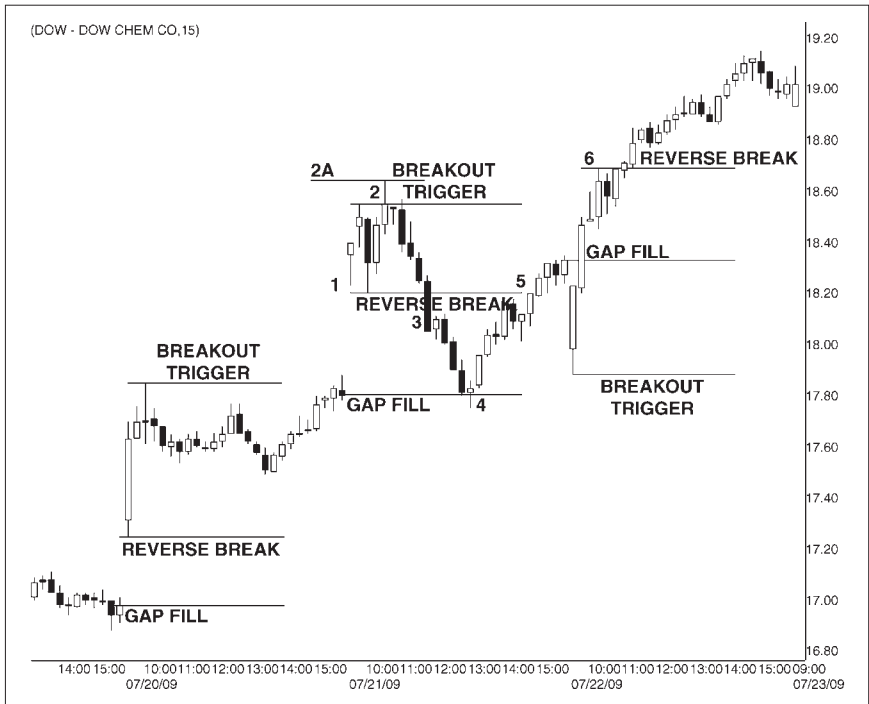
It's the morning of July 20. You've been watching Dow Chemical grind sideways at resistance near 17 for several days. Figure 10.11 illustrates the stock as it gets a tier one upgrade in the premarket session and then shoots higher, opening at 17.25. You settle back and wait for the first hour range to set up with four 15-minute price bars. The buy signal then triggers when price exceeds the range high. If you were contemplating a short sale after a gap down, the sell signal would trigger on a selloff through the range low. The early range, in either direction, often needs to complete a testing phase before it yields to higher or lower prices. As a general rule, look for the instrument to reverse the first time it tries to exceed a high or low but then succeed on the subsequent try. This frequently carves out a tiny cup and handle or inverse cup and handle on the intraday chart.

You draw a line at the prior day's close. This marks out the "gap fill" line that will come into play if the early range breaks in the direction of the gap. Then, as soon as possible, you draw two lines that mark out the range high and low. The line nearest the gap fill becomes the "reverse break line." The other line becomes the "breakout trigger" line.

The first hour range is a general guideline that needs custom fitting to the individual trading plan, market being traded, and daily collaring

FIGURE 10.11

Dow Chemical gap analysis.



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strategy. This is often a matter of trial and error. More aggressive traders can shift in close and use three or four 5-minute bars to establish the early range rather than waiting the full hour. More defensive players may skip the intraday arena entirely and look for a breakout or breakdown from the two- to four-day range after the gap print. Even the first hour strategy requires flexibility and a little common sense. For example, it might take 45 minutes or two hours for price to establish a range that can be used for your trading signals. Also, consider the high noise levels on 15-minute charts. A breakout that extends just a tick or two can be easily reversed, so the exact entry price is a judgment call until the intraday trend finally gets established.

Next, you look at relative location. Does the opening bar push price into, or through, longer-term support or resistance? An up gap might force a stock above several resistance levels and plant it firmly on top of new support, or it can push it straight into an impenetrable barrier from which the path of least resistance is straight down. On the first and second Dow Chemical gaps, the stock has broken out above resistance and will trigger a long-side entry signal as soon as price rallies above the first hour range, or breakout trigger line.

What happens if price goes the other way? The support line in a gap up and resistance line in gap down are also known as reverse break lines. Violation of the reverse break is likely to trigger price acceleration toward the gap fill line, which marks the unchanged level from the prior session. Consider why this price thrust makes perfect sense. Everyone who enters a position in the direction of the gap is losing money if price violates the reverse break line. In turn, stop losses start to trigger a domino effect that expands price against those positions.

The gap fill line marks support in an up gap and resistance in a down gap. As a result, the odds favor a reversal back in the direction of the opening trend as soon as price touches this line. Paradoxically, this is an unfavorable spot for traders to enter new positions because the reverse break line should now resist price from reentering the early range. In fact, it's common for a financial instrument to bounce like a pinball from the gap fill line to the reverse break line and back through the gap fill line, triggering a failure signal because it predicts a significant reversal.

The flip side of this reversal is a failure of a failure signal in which price pushes back across the reverse break line, setting up a retest of the high after an up gap or low after a down gap. The resiliency needed to cross the reverse break line and retest those levels issues a generally reliable signal to take positions in the direction of the gap. These signal dynamics are easily understood. In an uptrend, the positive action exposes buying power that often precedes a rally to a new intraday high. It's a great trade because the risk, once the buying signal is taken, can be well managed with a stop loss just below the reverse break line.

Getting back to the initial Dow Chemical breakout in Figure 10.11, price sets up a first hour range and then grinds sideways through the rest of the session, never triggering a buy or sell signal. The buy signal actually comes at the start of the next session (1), when it gaps higher for the second day in a row. In turn, this sets up a fresh iteration of gap dynamics. The stock wobbles sideways for an hour in a range between 18.20 and 18.58. You add to the position when price breaks out of the

range (2) and get shaken out immediately by a sudden reversal. You then redraw the breakout trigger line (2A) to acknowledge the whipsaw. The early failure attracts sellers who drop price into the reverse break line in the late morning hours. The stock breaks down (3) and surges into the gap fill line (4) right after midday. Support kicks in right on schedule, lifting price back into resistance at the reverse break (5), where it stalls for an hour and then jumps back into the early range. This failure of a failure buy signal should yield even higher prices, but the market closes before price can rally into the other end of the early range.

The stock then gaps for the third day in a row, but this time around it's a down gap that finds support just above the gap fill line of the prior session. The opening selloff triggers a fast-moving market in which buyers fill the gap in the first 20 minutes. The recovery keeps on going, reaching 18.70 and stalling out. This buying spike yields a crazy quilt of signals, with the reverse break line now marking the location of our next entry trigger (6) rather than a failure line, because it's situated higher than the gap fill line. This paradox looks less bewildering on a two-minute chart because the gap gets filled well before the end of the first hour.

Ironically, few easy buy signals trigger during these three gap days. In fact, you wind up losing a little money for all of your hard work. However, price dynamics after the gaps work out as expected in each session. With these reliable mechanics now hardwired into your consciousness, you're ready to master a broad variety of gap patterns that confuse and confound other market players.

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MANAGING RISK AND REWARD

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11

C H A P T E R

THE NATURE OF LOSING

New traders come into the financial markets with a single-minded goal: to make lots of money. Regrettably, the market knows you're coming, understands your greed, and has erected perfectly diabolical mechanisms to ensure your objective is never reached. In fact, the obliteration process is so complete that nearly 90% of all traders eventually lose their stakes and wash out. Even old pros suffer the wrath of this perfect destruction engine, wiping out years of hard work and careful knowledge accumulation. The evaporation of nearly \$40 trillion in U.S. retirement savings in the 2008 crash tells us that wealth destruction isn't limited to a small cadre of speculators and other short-term market players. In reality, long-term investors are nothing more than traders playing very long time frames. And since boom and bust dynamics persist through all market cycles, bad karma eventually catches up with every strategy and point of view, whether you're a day trader or a deep-pocketed value investor.

On the other hand, the trading loss is an absolute prerequisite for taking consistent profits out of the market. In truth, even the most

successful strategy carries just a small mathematical edge, which ensures that many stop losses will get hit in the process of wealth creation. Sub-consciously, most of us try to avoid losses, thinking these are aberrations on the road to profits, but that just isn't true. In fact, it's our job to embrace losses and the vital lessons they teach us about current market behavior. Just like small children touching hot stoves, we get actionable data from trading losses about the quality of the ticker tape and how our strategies need to adapt in order for us to make money.

The requirement for constant losses on the road to profits is more than many traders can handle because our emotional hardwiring takes each loss personally, magnifying the negative aspects of our personalities. This isn't a huge problem for well-adjusted individuals who cope well with the broad swath of life's challenges, but it can be a game breaker for marginal individuals with self-esteem issues or an inability to cope with adversity. In addition, nearly all traders have spouses, siblings, neighbors, or authority figures who disapprove of their market activities because of the media's negative portrayal or the legitimate fear that core wealth is being placed at risk. This combination of internal pain and external disapproval forces many traders to operate in an adverse environment in which each loss becomes an affirmation of personal inadequacy and the next topic for discussion at the family dinner table. In both cases, profitability becomes a more distant goal, while giving up and moving on becomes the only pain-ending alternative.

Hopefully, Part Four made it crystal clear why adequate capitalization is so important if you want to trade the markets successfully. In a nutshell, the myriad obstacles faced by new traders become far less daunting when (a) the trading account is large enough to withstand large drawdowns, and (b) trading risk comprises a relatively small share of total wealth. That's why market mentors tell us to trade only the amount of capital we can afford to lose. This isn't idle advice. And, as peculiar as it sounds, no one should enter the trading game with the objective of earning a living from it. That comes later, after you've proven to yourself and everyone else that you can make money and then hold onto it for long stretches. Until that magical day comes, your only job is to trade well and not worry too much about paying the bills.

The next axiom represents the single most important piece of advice I can give to the survivalist trader. Simply stated, your long-term success depends on cutting losses rather than chasing profits. Because this is true, knowing when you're wrong is the most profound skill you can learn in market speculation. Consider the three aspects of this defining statement:

- Your razor-sharp focus needs to be on the loss side of the equation. This is better known as risk management.
- Profits come as a result of risk-based activities, not because you're trying to make money.
- You can't cut losses efficiently until you can recognize the exact moment you're wrong on every bad trade.

Unfortunately, traders participate in the markets for many reasons that have nothing to do with profitability. It's a psychological thing in which secondary reinforcement, rather than a narrow focus on the bottom line, guides our hand. Clearly, this endeavor sets off measurable physiological changes, like the adrenaline rush when we enter the market, the exhilaration when something goes our way, and the crushing sensation when we incur big losses. Ironically, riding a roller coaster at your favorite amusement park will mimic each of these specific sensations. While long-term profitability is our stated goal for trading the markets, many nonfinancial impulses come along to undermine our discipline. At the top of the list: it feels damn good to take on financial risk, whether or not we make money, so we seek out this behavior even when there's no opportunity. Not surprisingly, this is the primary cause of overtrading and mediocre performance.

Here are three more reasons we trade, even when it doesn't help our bottom lines. First, trading supports our social lives because we have an exciting subject to discuss with friends, neighbors, and first dates. Second, it makes us feel powerful, even if we're total losers in the rest of our lives. Finally, it relieves boredom by filling our brains with extraordinary hopes and dreams.

To reiterate a key principle, most traders will eventually fail due to a lack of discipline rather than a lack of knowledge. I've taught hundreds of students over the years, and understanding this key piece of wisdom is their greatest challenge because new traders believe there's a holy grail that, once found, will unlock all of the market's mysteries. Nothing could be further from the truth, and to twist Einstein's famous observation, successful trading is 1% inspiration and 99% perspiration.

Long-term profitability also requires that we make our peace with the vagaries of the financial world, including a middleman system that rarely favors the little guy. In return, this acceptance opens the doors to improved performance, year after year. No, it isn't good enough to be focused on skillful action just part of the time. Taking money out of the markets demands absolute precision in all of your actions, from Monday's confused

open to Friday's closing bell. Sadly, even a momentary lapse in concentration can trigger dire consequences. This is especially true in a modern day environment that's unforgiving to traders at all experience levels.

THE PERFORMANCE CYCLE

Every market participant goes through winning and losing periods. In a down cycle, mediocre traders will lose as much as or more than the profits they book in an up cycle. Meanwhile, good traders take defensive measures during down cycles and hold onto the majority of their up cycle gains. This profit reserve sets the stage for the next up cycle, in which they build even greater returns ahead of the next down cycle. Of course, good traders go through bad drawdowns at times, while mediocre traders enjoy amazing runs in which everything they touch turns to gold. Those winning periods are especially damaging to marginal players because they build a false sense of entitlement. In turn, the delusion eventually generates higher amplitude down cycles that can trigger catastrophic losses. And so it goes, cycle after cycle, until the mediocre trader washes out and the good trader achieves consistent profitability.

Performance cycles coexist in multiple time frames, just like your favorite charts. Using myself as an example, I know there will be one or two days in every two-week period in which risk escalates through the roof, turning marginally bad positions into high-cost nightmares. My only defense is to recognize these days as early as possible and to cut my exposure to the bone to avoid the buzz saw. This is a psychological as well as tactical issue because the favored trades that usually fill my coffers are the same ones drawing blood during those high-risk sessions. Given my tendency to aggressively trade the setups I know and love, switching gears and sitting on my hands can be a demanding task, to say the least.

Large-scale performance cycles usually track broad market direction. For example, if you're a long-biased trader, corrective periods generate all sorts of losses while you play a buyer's game that no longer works. Conversely, short sellers go through long stretches of fighting the tape and paying the price but then take home windfall profits when the market finally falls from its own weight. The intimate relationship between personal bias and performance cycle needs to be addressed and deconstructed in order for the trader to survive and prosper in the long term. Theoretically, the swing trader is just an opportunist, ready to pounce on good patterns in either direction. However, in the real world, most of us

favor one side of the market over the other. So, breaking this lopsided relationship requires (a) a recognition that you fall into the long or short category, and (b) a strategy to deal with markets that are moving in the opposite direction of your bias.

The long- or short-biased trader will recognize the onset of adverse market conditions by unexpected losses on favored setups. Trade frequency should be reduced immediately when this happens, while a search for sectors still favoring your bias gets under way. For example, the U.S. indices selling off after a long rally can take the entire stock universe with them or just a few overheated sectors. In addition, commodities and foreign markets often move against the downward tide, offering long-side trades through an entire index decline. Holding periods can also be adjusted to sidestep a falling market. Zoom out to the weekly charts and look for pullbacks within the larger-scale uptrend. Then stalk your candidates for weeks, if necessary, waiting for price to pull into substantial support. Finally, buy in pieces, using the averaging techniques outlined in Part Four, with the intention of aligning the bounce with a turnaround in the broader indices.

A second holding period strategy for the long-biased market player during a correction is to become a day trader, playing small uptrends that develop within broader down cycles. In fact, day trading as a defensive strategy is a highly effective methodology for dealing with a variety of adverse markets.

The next step in managing the performance cycle is so boring that most traders don't want to hear it. Simply stated, sit on your hands and wait for a more supportive market. Most of us can't generate equal edges in both directions, so any effort to reverse our strategies because the market has shifted gears ends in failure. In many cases, the best plan is to stay out of the action until it supports your particular game once again. Of course, this is easier said than done, which brings us back to a major theme in this final section. The sad truth is, if you don't learn to sit on your hands when required, you're going to fail and wash out of the markets. Hopefully that thought is scary enough to force you into a disciplined approach when it's needed.

The markets operate through an inefficiency engine that sets up good trades at key intersections of price and time. In between these points of light, trading is often volatile, choppy, and downright treacherous. By focusing your efforts on points of genuine opportunity, you apply capital and emotions where they will do the most good. Trading in the gray zone usually won't cost you a fortune, but it will undermine your discipline and dull your senses. At a minimum, you might not be ready to act without

hesitation when the next real opportunity comes along. I can't tell you how many times in the last two decades I've chased around shadows and then failed to pull the trigger when a great setup appeared out of nowhere. Of course, it always turned up at exactly the same time I was burned out from a bad trade and hating the market for ruining my week. At that point, it was a tough chore to clear my head and take on risk, so I did nothing and wound up kicking myself later.

Notice how your perception changes when you move back to the sidelines after a bad trade. The fog lifts and you feel reenergized because risk has been removed from the equation, which is the major benefit of getting out of the market. Sometimes it's even a good idea to dump a profitable trade, just to look at things without the bias induced by position risk. It's absolutely amazing how much easier it is to read the market when you have no stake in its outcome. In fact, I know you've missed thousands of signals over the years because your positions blinded you to what was right in front of your nose.

Standing aside becomes even more valuable after a large drawdown. Our first instinct when we lose money is to get back on the horse immediately and try to recover our losses. But that's often the worst thing we can do because the effort focuses on getting even, rather than on managing opportunities. Logically speaking, big losses are telling us we took the wrong risks at the wrong time. Stepping back to the sidelines lets us review the situation in detail without doing any further damage. It also gives us the opportunity to evaluate our losses from a more objective viewpoint. Not surprisingly, this data mining often leads to a longer break from the action while we recharge our batteries.

Want to enjoy the financial benefits of moving to the sidelines? Here's an exercise that will improve your bottom line results immediately. Go over your trading results in the last year, and compute the number of positions you entered each week. Then commit yourself to cutting the average number in half for the next month. You'll be amazed at how this small decision affects your perception of opportunity because it forces you to become selective in your choices, while it opens your eyes to the perfect setups you've been missing while you were chasing your own tail.

OVERTRADING

It's easy to get so addicted to the price action that we trade for the adrenaline instead of the profit. This obsessive behavior leads to overtrading,

which is a popular disease in our fast-fingered markets. It's also one of the hardest flaws to conquer, because it doesn't vanish with experience. In other words, both newbies and lifetime pros overtrade with equal vigor. Most traders find themselves in the following scenario from time to time. They get into a groove and respond by doubling or tripling their usual number of positions, which almost mystically ends their winning streaks dead in their tracks. We have just two logical choices when we find ourselves in this frustrating situation. First, recognize the danger, shift back to smaller size, and get back into business. Second, ignore the feedback, lose control, and blow up with even bigger losses.

It's easy to talk about self-discipline, but the heat of the moment can be overwhelming. The endless daily grind often wears on our concentration, making us forget the most basic trading lessons. Bad mornings are an especially destructive force. In fact, a few losses on Monday morning can trigger a domino effect that spirals into a week of overtrading, dwindling capital, and reduced confidence. It's even possible to lose so much money through overtrading that we get "numb" and stop caring about our losses. This is very hazardous because it removes the fear factor while doing nothing to wake up our discipline and get us back on the right track. Sadly, many traders wash out of the markets when they hit this turning point, because their senses become too dull to recognize impending catastrophe.

How can you overcome the overtrading monster? Many times, it takes a severe beating to wake up from this nightmare. When the new dawn finally arrives, immediate changes to your trading style are required in order to avoid a repeat performance. Start with a detailed diary in which you write down every position you take and why it's worth the risk. Then keep one eye on your losses at all times, shutting down the computer and walking away when you reach a predetermined daily or weekly limit. Not surprisingly, choppy markets trigger more overtrading than trending markets, so step back before the day begins and figure out exactly what type of market you're trading. This collaring process, discussed later in this chapter, can lead to profound changes in your strategy, self-discipline, and performance. To see why this works, open up your diary and compare your worst days to the overriding trend during those sessions. Most likely, you were fighting the tape with an inappropriate collar.

It's easy to write down rules that tell you when to enter or exit the market. The problem arises when they stop working, even for a little while, because we live in an instant gratification culture and expect to be rewarded every single day. So when we lose a little money, we assume our rules are to blame and start overtrading in order to find new ones. It's even

worse when we make money through overtrading. In this incarnation, the mindless gamble pays off and reinforces an undisciplined approach, but the diabolical market ultimately extracts its revenge and takes away what was given in error. And it doesn't stop there. It then attacks our seed money because we've become reckless. In the end, our lucky trades wind up costing a lot more than a simple string of bad trades.

Those who fail to learn from overtrading binges are doomed to repeat them. Fortunately, you can end this destructive cycle with an honest review, looking for common themes and a triggering event. You might find it starts after a big bet blows up in your face, or a big profit turns into a big loss. And don't forget the ultimate frustration of missing out on a series of good trades. That disappointment can set off a negative spiral in which you try to get back at the market for your own failure to pull the trigger. The bottom line is, the markets have no ego and are not out to get you. They just go up and down and don't care about your opinion. The sooner you realize there's no revenge factor in trading, the easier it will be to reestablish the discipline required to avoid the overtrading monster. That realization will finally let you watch the markets with an open mind and trade only when the true signals appear.

TRADING MISTAKES

Neophytes think their trading mistakes will vanish after a few million hours of experience, but that just isn't true. Even professionals still make costly mistakes that should have been avoided. Trading mistakes run the gamut from mental errors to misguided opinions. The most common ones also cause the most damage. For example, just consider how much money your bullishness cost you in the last two bear markets.

Trading mistakes can't be eliminated, but you can curb their considerable influence. Start by listening to the little voice in your head, and let it question every decision you make. In no time, you'll uncover a dozen ways you're losing money for no good reason.

Fortunately, we can control our own fates most of the time. To this end, it's vitally important to recognize the circumstances that place us at the most risk of making bad decisions. Realistically, the following scenarios will keep draining our accounts, but their impact can be reduced substantially when we see them coming and initiate defensive countermeasures:

1. **Out of sync.** There's nothing worse than playing a trend in a choppy market or a chop in a trending market. Make sure you know the type of environment you're trading before pulling the trigger.
2. **Pressing the bad.** You don't want to admit it when you're wrong, so rather than cut your losses, you press on with bad positions, trying to turn lemons into lemonade.
3. **Cutting the good.** You're in a great trade, but something inside doesn't want that wonderful experience, so you exit with a small profit just before the position takes off like a rocket.
4. **Being early.** You get ahead of yourself by jumping into a position that isn't ripe and get shaken out just before the pattern does exactly what you expected.
5. **Being late.** You're unable or unwilling to pull the trigger on a great setup, because you're waiting to see what everyone else does. As it turns out, everyone else is ready to get out by the time you're ready to get in.
6. **Bullishness.** You think the market is ready to go up after every leg down, forgetting that real buyers can be real hard to find at times.
7. **Bearishness.** You spend more time listening to doomsayers than reading the charts and miss buying opportunities, even when they're smacking you across the face.
8. **Ignoring gravity.** Markets go down when they can't find buyers, regardless of how few sellers are out there at the time.
9. **Forgetting the big picture.** You get so wrapped up in current events that you forget to step back and check out the weekly or monthly charts.
10. **Forgetting the little picture.** You confuse macro events with micro plays and let the big picture obscure what's right in front of your nose.
11. **Fear of the squeeze.** The squeeze crushes short sellers in the early phases of downtrends, but your anxiety is misplaced when negative momentum replaces a two-sided tape.
12. **Last to the party.** The fear of missing out overcomes your better judgment, and you jump in. The trend ends immediately, and you're stuck holding the bag.
13. **Margin fever.** You have a small account but want to be a big player, so you overtrade margin and get into a heap of trouble.

14. **Getting even.** You lose money and vow to get it back the next day or next week. Bad move, Charlie Brown, because you've just abandoned your trading plan.
15. **Listening to pundits.** You shoot yourself in the foot because you let someone else tell you what to buy or sell.
16. **The agony and the ecstasy.** Pleasure makes you feel like Mr. Market, setting you up for a big fall, while pain attracts positions you don't want and can't control.
17. **Chasing the open.** You go to bed so excited that you can't wait for the next day's opening bell. Guess what? You've just put a big target on your back.
18. **Software fever.** Pretty colors can't make you a better trader, but they can make you a poorer one. Sadly, kilobytes are no cure for a lack of skills.
19. **Lottery ticket.** How often do you carry a position into an earnings report, hoping to get a pop from the news? Hmm, I thought so.
20. **Counting your chickens.** You forget that profits on open trades aren't real until you put the green into your pocket.

DRAWDOWNS

Drawdowns trigger all sorts of psychological and logistical issues. For starters, it's hard to trade after incurring a series of losses because the assault of red ink undermines our confidence, making us second-guess the strategies that worked so well in the past. Simply stated, this commonly shared pain is a wake-up call to adjust our approach and to reduce risk exposure. Even the best traders can't avoid drawdowns because losing streaks are a natural outcome of playing the financial markets. Of course, it's doubtful that this piece of wisdom will make you feel any better the next time the market is beating you up.

The trader needs to regain emotional control quickly during a drawdown period and maintain a positive attitude about losing money. I know this is hard to accomplish in real time, but despair and profit rarely travel together, and it's very easy to turn a string of moderate losses into a full-blown disaster. Strategic adjustments to your methodology will also quell the emotional fires. At the top of the list: reduce position size and don't try to recoup your losses in one high-risk trade. Smaller positions let beaten-down traders get their minds back into harmony with the market

flow. Obviously, the reduced profits can't undo the prior damage, but they will help to reestablish the methods and workflows that paid your bills in the past.

Drawdown periods force traders to experience a level of impotence that can be very frightening. You might discover your assumed profitability came during a period when everyone else was making money and then realize those happier times induced ego gratification and a false belief you had become a gunslinger. That particular wake-up call has two equal and opposite outcomes. First, it can force the marginal trader to wash out of the markets and move on to a safer hobby. Second, it can motivate the serious-minded trader to fathom how the markets really work and what it takes to survive in all types of environments, good and bad.

Identify your "fail-safe" drawdown level early in your career. This is the maximum amount you're willing to lose before turning off your screen and walking away from the market. This hiatus need not be permanent. Rather, it's a physical recognition that things have gone wrong and a period of self-analysis is required before taking on fresh risk. This vacation from the market lets weakened traders examine personal issues that may be hidden in the heat of day-to-day battle. It also gets them into bed at night without fresh losses weighing on their minds. Indeed, this abstinence often ends the drawdown cycle and fosters instant success when they finally return to the action.

The pain of a drawdown will turn you into a more profitable trader if you listen closely and adapt quickly to its embedded messages. But the same pain can easily destroy your financial ambitions if you choose to ignore the wake-up call. The bottom line: do you want to fight the market and your personality, or do you want to make money? The key difference between good traders and bad traders is how they turn their drawdowns into acts of personal power or personal misery. Let's face it. We're all shocked to find out we're mere mortals when the tables turn and we start to take big losses, but the experience exposes us to the truth serum we need to survive and prosper in the long term.

Many traders blame drawdowns on everything except their failure to recognize and respond to a changing market environment. This is pure denial because we have tremendous input on our losing streaks. At any time we can lower position size, trade less frequently, or just sit on our hands until the odds are back in our favor. Instead, many folks just ignore the danger and keep throwing money at strategies that have stopped working. This self-inflicted pain usually doesn't stop until they finally incur enough losses that reality gets into their thick heads and tells

them things have gone horribly wrong. Ironically, these individuals fully understand the performance cycle but still believe the giveback phase will magically disappear over time. Sadly, they don't realize this stumbling block, exemplified in the yo-yo trader, marks a final obstacle that can limit profitability for the rest of their careers, no matter how much they pray to the trading gods for relief.

SELF-DESTRUCTION

It's tough enough to trade successfully when hidden forces are picking our pockets each day, but it's even tougher when we get sidetracked by self-destructive habits. That's why we need to identify and control inappropriate behavior that bleeds into the trading day and sets us up for failure. This cleansing process starts by recognizing when delusion replaces reality in our daily mindset. Consider these warning signs. Do you think you're losing money because the market is rigged? Do you believe you'd be profitable if the brokers, computer programs, and hedge funds would just get out of your way? Do you think your losses stem from the opinions of a guru, analyst, or talking head, rather than from your own actions?

At its core, trading is a process of awakening to your personal power. This can be an impossible leap after years of playing the blame game because you've abdicated your control to a conspiracy theory or a rigged deck. The damage done by this self-sabotage can be brutal and widespread. The only way to climb out of this dark hole is through tortuous self-examination that begins with detailed record keeping, so you can go back and reconstruct your motives for each trade. Indeed, one of the hallmarks of destructive trading is poor record keeping because the lack of a personal history allows the trader to prolong the actions that lead to destructive outcomes. Unconsciously, most of these individuals don't want to change how they're playing the markets because the bad behavior gives them all sorts of secondary reinforcement. In a perverse way, the endless losses become a major addiction that's hard to break.

Destructive trading usually revolves through an insidious cycle. First, the trader enjoys a series of profitable days and starts to recover lost equity. Mental attitude improves, and self-confidence makes a return appearance. Then danger reappears in the form of a toxic position that looks benign at first glance. The improved mental state now works against

the trader who fails to note the hidden risks. A worst-case scenario then kicks in, with a devastating loss that hurls the trader over the cliff and back down to planet earth.

You can also defeat this monster by focusing religiously on the loss side of the equation rather than worrying about profitability. In other words, your daily efforts should incorporate a spectrum of self-checks and loss avoidance techniques. These include limiting total entries to the absolute minimum, reducing position size on each trade, and placing rigorous stop losses. Supplement these techniques by choosing shutdown levels to incorporate into your overall strategies. For example, you might decide that \$250 is the maximum loss you're willing to incur for all trades on a given day. Close out everything once that level is hit, and walk away for the rest of the day. This is tough love because destructive traders get needed proof about their personal inadequacies at each downturn of the equity curve, which raises an unconscious desire for more losses.

Those who ultimately find success in the markets emulate those who are already successful. So what do consistently profitable traders look like? They're normal, well-balanced, and content individuals who have mastered the highs and lows of their profession. They lose money but don't get depressed, make it but don't become elated, and keep a colder heart toward their discipline than you might expect. Above all else, these individuals play their own games and don't really care what the rest of us are doing, because they already know exactly what they want to do. Over time, they've learned to coexist peacefully with their trading demons and never blame anyone but themselves when things go wrong.

WASHING OUT

Playing the markets is a difficult way to pay the bills, but you're drawn to it anyway because staying at home and working in your pajamas is living the capitalist dream. But this discipline is not for everyone. No one is printing money, and the majority of traders will eventually wash out and move on to other hobbies long before they spend quality time in their jammies.

Emotions, physical health, and your pocketbook are the best places to look if you're thinking about giving up and walking away. Trading is real hard work that raises blood pressure, anger management issues, and

all kinds of self-doubt. A certain amount of stress goes with the territory, but it's time to find a new recreational pursuit when physical symptoms start to overrun body chemistry. There's no benchmark for bottom-line capitalization or drawdown size before washing out, so red ink might not push you to the sidelines. Paradoxically, many folks lose a fortune trying to make a buck but continue to trade anyway, while others cry uncle and call it a day after burning through a few pennies or dimes.

Each of us has different reasons for playing the markets, so no single overriding flaw seals the fate of the unsuccessful trader. In the end, only brutal honesty and self-examination will tell you when it's the right time to go. Of course, you should already know whether or not you have the *talent* to trade successfully. This is a wholly different issue from examining the fate of your bottom line. Great traders may not achieve greatness in their first few years of trading, but they get a market sense they can taste and touch very early in the learning curve.

Here are 10 more ways you can tell if it's the right time to call it quits:

1. Everyone needs trading rules. The ones you write down should include a loss limit where you'll take a permanent vacation.
2. Examine every one of your losing trades, and then quit the game immediately if you can't learn anything new.
3. Talk to your spouse, kids, and family pets. If any of them show physical distress because of your trading, cancel your subscription to the *Wall Street Journal*.
4. Do you see trading as a form of entertainment? The truth is that most of the time, trading is no fun at all. If you want fun, quit trading and join a rock band.
5. Ask yourself how badly you want to trade. If you see yourself doing this for the rest of your life, stay in the markets and take the pain.
6. Trade to the point where you're following all of your rules but still losing money. Then decide whether it's your rules or your trading that needs to go.
7. Just quit and forget about the markets, right this minute. If that makes you crazy, start trading again because you were on the right path in the first place.
8. How much can you really afford to lose? Head for the exits if that number is coming at you like headlights on a dark road.

9. Brutal honesty and self-examination will tell you when it's time to go. Is this just a bad year, or is every year just another bad year?
10. Do you have a history of success when taking risk, or is your life a string of misfortunes, misdeeds, and misfires? If the latter, get out before you crash and burn.

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12

C H A P T E R

CAPITAL PRESERVATION

Why do great trade setups fail, while lousy ones move in our favor? The answer is simple, yet quite frustrating. Trading is an odds game in which anything can happen at any time. In other words, price will go where price wants to go, no matter how hard we hit the books, study the charts, or pray to the deities. So rather than searching for the perfect trade that works 100% of the time, we're much better off stepping back and learning how to control risk. This is a tough task because, as odd as it sounds, many of us don't understand the nature of risk in the first place. Take this little quiz:

- Do you still buy how-to books, even though you've been trading for years?
- Do you sit in miserable losses because you hate to be wrong?
- Do you reject classic market wisdom because it cost you a few bucks long ago?

If you answered “yes” to any of these questions, you probably don’t understand how risk really impacts your profit and loss statement.

Calculate reward:risk before every trade, letting those numbers and conditions guide position management from entry to final exit. To reiterate a key point in Part Three, price close to substantial support identifies a low-risk long-side setup. Price close to substantial resistance identifies a low-risk short-sale setup. The distance between your trade entry and the next obstacle within your holding period measures the reward and intended exit. The distance between your trade entry and the price that breaks the setup measures the risk and unintended exit. Survivalist traders put the odds firmly in their favor by taking trades with high reward and low risk.

The best swing trades exit in wild times, just as the trend approaches a strong barrier. Reward planning seeks discovery of this optimum price prior to position entry. This profit target sits at a level where risk will increase dramatically if and when the trend strikes it. Traders should exit immediately when this profit target gets hit, or at least place a stop that locks in partial profits in case of a reversal. Conversely, every setup has a failure target, or the price that busts the trade. The best entries require just a small wiggle to signal a bad outcome and the need to jump ship. You’ll find these decision points just behind the convergence of support-resistance, like a violated moving average, a broken triangle, and a filled gap. The failure target changes dynamically after position entry, so you need to consider the impact of the last bar on evolving reward:risk and adjust the plan accordingly.

In Figure 12.1, Senior Housing Properties Trust sells off to 18 after a strong uptrend. It bounces to the 50% selloff retracement (1) and ticks lower in a 60-minute bull flag pattern. The stock gets upgraded prior to the open on August 27, triggering a breakout that pulls back to flag support (2) and then surges to a new daily high (3). The profit target lies at the 100% selloff retracement (4) in this scenario, while the failure target is located under the gap fill (5) within the bull flag, because a selloff into that level would signal a failed breakout. The reward:risk computes to a favorable 9:1 ratio. Of course, the stock might turn at the 62% retracement (6), which marks mild resistance, but the daily pattern shows wide open Bollinger Bands (not shown) into 21.75, predicting the rally could reach the early August high with little difficulty. In either case, the trader can manage the profitable position proactively, depending on real time feedback after entry.

FIGURE 12.1

Senior Housing Properties Trust breakout.



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Risk management starts with the acute realization that the market is a very dangerous place. Once we comprehend this fact of life, the actions we need to take in order to survive become more intuitive. Before assuming new risk, take a moment to look in the mirror and ask yourself what you're going to lose if things go bad. You'll be amazed how this simple inquiry can open the door to opportunities you can't see when focused solely on the profit side of the equations. For example, a seemingly marginal trade becomes a fantastic position if there's practically no risk in jumping on board.

Determine the exact dollar figure that represents the maximum loss you're willing to take on a single trade. Then do the math and make sure your exposure won't exceed this magic number, except after a shock event. If things don't add up, stand aside and wait for less risk or reduce your position size. You can also dip your toe in the water with a small position when you're not sure what kind of risk you're taking on and add to the trade once the small piece eases into a profit. Then just focus on keeping the total position as a "free trade," regardless of the original pattern. The bottom line: fantastic things can happen when there's no money to lose.

Place profit and failure targets in the ideal world, but trade in the real world. It's easy to ruin a great position by asking too much of it, so feel free to abandon your targets if market conditions change. For example, it makes no sense to risk a profit trying to squeeze the last few pennies out of a good trade. Also keep in mind that the market goes into trend mode a few days each month. Price bars can slice through support or resistance levels like butter in those one-way sessions and trigger stops faster than a game of Whack-a-Mole. Use common sense when you're caught on the wrong side of a trend day and get out of the way, whether or not your profit targets have been reached.

Exit your trades to book profits, take losses, or close mediocre positions. Emotions usually run high at both profit and failure targets, so take a deep breath and clear your mind before choosing to close out a position. Take your profits early or late, but never in between. For example, you get your trend and are looking for a big winner, but the market then stalls out and threatens to reverse. You have two workable choices: (a) take your money right away, or (b) sit on your hands through the pullback. Unfortunately, many folks find themselves in the third and unworkable choice, i.e., they panic on the retracement and exit at the worst possible time, just before the position recovers. Most traders want validation for their ideas, so they wait to see what other traders are doing before they act. This is a great way to become a bag holder on every position. Instead, close the time and sales ticker and focus your undivided attention on the trigger numbers where you should be in or out of the position.

Finally, develop a basket mentality. Your capacity for risk increases dramatically when you manage positions as a group rather than fretting over individual winners and losers. Start the day by considering how much total exposure you want to take on or eliminate during that session, i.e., your collar. Then initiate the required action across all of your positions and accounts to meet that objective.

TRADE COLLARING

The financial markets cycle through phases of opportunity and danger, with pattern cycles pointing out the true nature of the current stage. With this in mind, it doesn't make sense to play a tightly converged trend using the same strategy you would use for a choppy and divergent range. Collaring recognizes these behavioral shifts and adapts the trading plan to match short-term risk characteristics.

A trade collar is just like the one you put on your dog to keep him in check:

- Keep the market on a tight leash when risk is high and opportunities are tough to find.
- Loosen the collar and let positions "run free" when the market is trending, with a single-minded goal of ramping from one price level to another.

In other words, be aggressive in times of the greatest opportunity and defensive in times of the greatest danger. The collaring process works best when traders make small adjustments each morning in response to that day's reward:risk profile. But longer-term collaring is just as important in building the right exposure to major position trades and even multiyear investment portfolios. The collar signals when to let profits run and when it's the worst thing you can do. It also defines the right financial instruments to trade at any point in time. For example, it makes sense to play volatile small caps when the collar is loose and the market is printing money, but then stick with low beta issues and dividend plays when visibility is low and nasty reversals are the rule of the day.

Let's define the characteristics of an opportunistic market that demands more aggressive trade collaring. It starts with the index futures, which need to be trending higher or lower, in lockstep. Daily performance might vary, but these markets need to show nearly identical positioning in their current pattern cycles. This goes back to the issue of context. Ask yourself the following question: where are the indices trading in relation to big highs and lows as well as to charting landscape features like gaps, hammers, and retracements? Just like profit targeting, few obstacles on the index futures up to the next resistance level or down to the next support level increase the odds of a strong trend into that magnetic price.

Next, look at conformity between the index futures. Have they pressed above or below nearby barriers in unison, or is one still lagging behind? Consider how these markets acted when they came into the vicinity of the March 2008 Bear Stearns low in the second half of that year. The S&P 500 broke down first, in July, while the Nasdaq-100 held above that price level until September, when it also broke down. The subsequent convergence triggered one of the steepest declines in market history, with the S&P 500 falling 40% in just two months. This synergistic behavior isn't limited to generational crashes or bubbles. Rather, these inflection points set up continuously in smaller scales, with rapid price movement and fewer whipsaws when the index futures move from divergence into convergence and pass through major charting landscape features in unison.

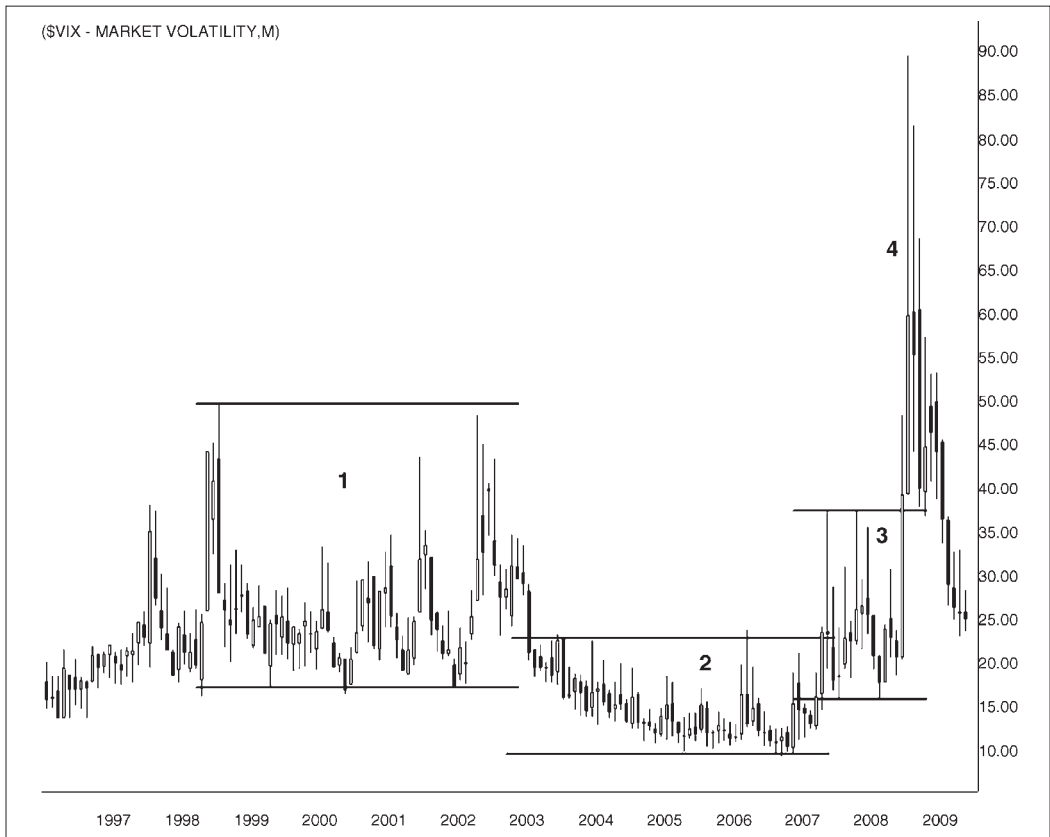
Market Volatility Index (VIX) defines opportunity and danger through absolute price levels and trending direction. The indicator swings up and down in multiyear cycles that generate relatively confined movement between floors and ceilings. In Figure 12.2, VIX carved out a four-year range (1) between 1998 and 2002, encompassing the tech bubble and subsequent crash. It traded between 10 and 25 for many years (2) after the 2002 low, pointing to a period of easy trading and relatively low risk. VIX then ramped higher in 2007, briefly entering a range between 15 and 35 (3) and then spiking up to 89 in the 2008 crash (4).

Trading risk increased geometrically when VIX broke 25 and again when it broke 35. The breakout over 35 in 2008 corresponded with the September index convergence that preceded the crash. This exposes a paradoxical aspect of trade collaring because that period was marked by both high opportunity *and* high risk. This combination demanded an extremely tight collar for most market players—i.e., to stay out of the game completely—but was a call to windfall profits for the minority with edges that could capitalize on the high volatility. Those edges, whether through sizing, scaling, stop loss management, or VIX futures, overcame the high-risk profile enough to tap into a historic profit opportunity.

Now take this aggressive-defensive approach into the intraday arena, where the index futures are grinding through tests at three-day highs and lows or trying to fill morning gaps. The same principles apply, with tight collaring when prices are stuck between testing barriers and loose collaring when those levels are mounted or broken in unison. Trend relativity comes into play with these mini-breakouts, breakdowns, and gap fills because the significance is tied to the relative location of price within daily and weekly patterns. For example, when the S&P 500 and Nasdaq-100 index futures rally above three-day resistance, your long positions are

FIGURE 12.2

VIX cycles.



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still at risk if a two-month swing high is sitting a point or two above the breakout.

Like so many things in the market, finding the right collar for that session or month is a complex puzzle requiring proper interpretation of multiple inputs. Fortunately, the task is made easier through simple application of Dow Theory, which always looks first at the sequence of highs and lows on the index charts. Just keep in mind that we're not using the classic indices described in Charles Dow's work nearly a century ago. Rather, we're focusing our efforts on the two index futures that have become the nerve center of the modern market environment.

Index direction is equally important if you're a long- or short-biased trader because the collar needs to tighten significantly when a trend develops in the opposite direction of your bias. This can be as simple as a natural buyer staying out of the market on a down day, or a natural seller switching to fixed income instruments in a raging bull market. Of course, adverse movement actually favors your bias at times by opening up more advantageous entry prices, but that's a collaring issue as well.

Say you're a short-biased trader playing the eBay downtrend off the October high near 41, illustrated in Figure 12.3. This is a loose collar environment, so you increase position size and hold on longer, trying to get

FIGURE 12.3

eBay short-side defensive collar.



a bigger piece out of each selling impulse. You catch a nice momentum move in which the eight-day SMA (1) acts as stubborn resistance. The Nasdaq-100 then bottoms out on November 12 (2), forcing you to tighten the collar because eBay is a tech stock and an index component. The market is also heading toward November options expiration. The five- to six-week period (3) between that expiration and the last day of December triple witching expiration marks a seasonally positive time because money managers routinely mark up stocks to paint the numbers for their year-end reports. The positive tone then continues through the holiday week but ends abruptly at the start of January.

The stock continues lower into the start of November expiration week. The S&P 500 then bottoms out (4), triggering index convergence and setting up ideal conditions for a short squeeze. You recognize the danger and shift into a sharply defensive collar by covering positions and avoiding the breakdown patterns that attracted your capital during the selling impulse. eBay reacts to the positive forces by reversing to the upside, closing above the eight-day SMA (5) for the first time in nearly a month and then gapping higher. As a short-biased trader, you're not interested in playing the long side because you have no edge, so you sit on your hands through December expiration while the stock fails three attempts (6) to rally above the 50-day EMA and 38% selloff retracement. You ease up slowly on the defensive collar during the holiday week because seasonal forces will come to an end when the calendar turns. This gradual shift lets you build pullback positions at resistance in anticipation of the next primary selling wave. The downtrend cycle then reasserts itself at the start of January (7), and you shift into a fully aggressive collar, adding to short sales as the bottom drops out and the decline resumes.

If you've read your aggressive-defensive cycles properly, you've exposed yourself to the market when it favored your strategies and were sitting on the sidelines reading a good book or playing a video game when it didn't. Now consider the game-changing impact of trade collaring on our boom-bust performance cycles. Since the majority of our losses come when we're taking edgeless risk, this simple filtering mechanism has the power to overcome years of destructive yo-yo behavior and mediocre annual returns.

Applying the right collar for a particular session goes well beyond simple index analysis. For starters, is the premarket setting up a sharp gap against your exposure? Losses triggered by overnight movement require a defensive collar, even if everything else is firing on all cylinders. At a minimum, the glowing red numbers are saying you're wrong about the

market, and, whether you like it or not, you'll start that session triaging losses, which will detract from a natural focus on other opportunities. The best strategy in this all-too-familiar scenario is to take a deep breath and deal aggressively with the matters at hand. Then, after the fires are put out, you can reconsider how you want to collar the rest of that session.

News flow also impacts trade collaring. Big events, like FOMC meetings and monthly labor reports, require defensive collaring that's independent of anything you're looking at on the index tickers. Simply put, index prices are manipulated into market moving news in order to encourage weak-handed positions. One classic example is the well-known tendency for the market to tick higher ahead of a Fed rate announcement. Marginal players are fooled into believing they're watching a reaction to undisclosed news at that time, when the uptrend is nothing more than an effort to trigger scalping plays and set up traps for later in the day.

COLLARING STRATEGIES

Execute your collaring strategy by adjusting position sizing, scaling into and out of positions, and altering holding periods. These three elements can handle just about any type of environment, from a raging bull market to a late summer chopping block. Shorten the holding period and decrease position size during dangerous times, and lengthen holding period and increase position size when the market is offering free money. Scaling into positions works best during adverse periods, because it lets you test the waters before taking a full measure of risk. Conversely, favorable markets support an all-in mentality that takes a 100% position immediately and then scales out slowly in order to maximize profits.

Risk increases as a function of your time in the market. In other words, you risk losing more money the longer you hold onto a position. Reviewing the discussion in Part Three, the most urgent holding decision comes at the end of the session, when you choose to keep the position overnight or to dump it and move on. This element extends into time-of-day strategy as well. First hour positioning works best when trends are clear-cut, and everything is moving in your direction. The first hour increases volatility, which you can use to build risk for that particular session. Readers of *The Master Swing Trader* may recognize this statement as a partial contradiction. It's true that times have changed, and just sitting

on your hands during the first hour, day after day, is a poor way to earn a living in the financial markets. However, it still makes sense to avoid the opening hour in conflicted or adverse markets. Wider ranges work against the trader at those times because price action is painting a picture that makes the session look “reasonable” to the greatest number of market participants. In other words, it’s easier to get fooled and make bad decisions when you think you see something interesting in the first hour of a non-supportive market.

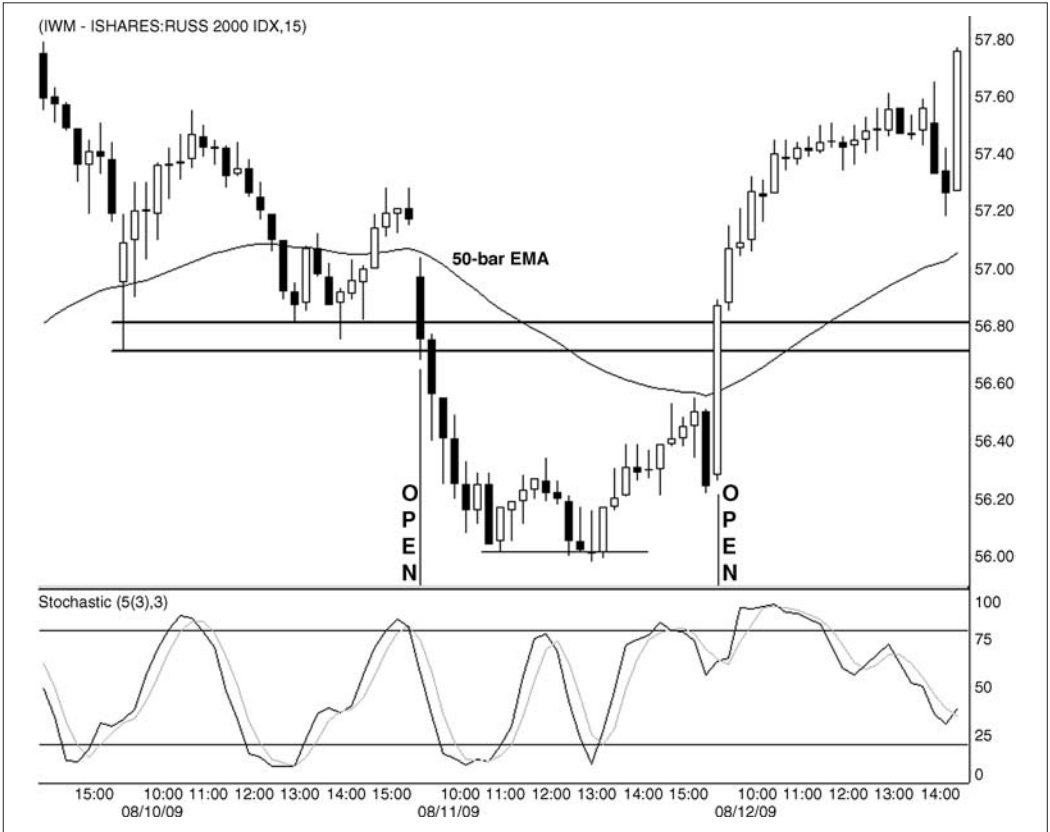
The lunch hour and last hour also mark important inflection points where collaring strategies come into play. Trend days, higher or lower, tend to stall around the lunch hour, while a countertrend impulse kicks into gear. At times, this reactive force is strong enough to flip over the day and begin a substantial retracement or reversal. Those are the sessions in which big bull hammers or shooting star candlesticks develop on the daily index charts. More often, however, the midday impulse fails and gives way to a test of the rally high or selloff low in the last two hours of the trading day. So, if your collar is set defensively because you’re a long-side trader and the market is selling off, it’s vitally important to steer clear during the midday countertrend and to honor your strategy straight through to the closing bell.

The final hour also brings the daily collaring strategy to an end. Traders need to be thinking ahead at this time, visualizing how closing prices are likely to impact the opening of the next session. For example, does selling pressure look washed out after a downside trend, with the evolution of two- to four-hour bowl-shaped patterns on the index futures? This rounding off suggests that sellers have had their say, with a buying impulse setting up in the next one or two sessions. In turn, this observation loosens the collar, with the trader considering long positions that might take advantage of the upcoming bounce.

Adjust sizing and scaling strategies to reflect the current collar. Limit your exposure to just one-third of total account size during adverse periods, when a defensive collar is utilized. Your two goals at that time are simple: to make a little money and to avoid losing a lot of money. Ratchet up total exposure to 90% of equity in supportive markets, and increase your holding period at the same time. These elements work together in recognition of the more favorable environment, trying to “make hay while the sun shines.” Save margin exposure for those rare times during the year when the planets line up harmoniously and everything favors your proven strategy. However, don’t trade margin, ever, if you don’t have a strategy backed up by several years of profitability. Also, be on guard for

FIGURE 12.4

Adjust your trading collar in the final hour of the session after reviewing intraday price action. The Russell 2000 Index Trust gaps down and breaks support at 56.80. It trends lower until the late morning and then eases into a sideways pattern through the middle of the day. The quiet action generates a double bottom and mild uptick into the last hour. The trader, sensing that selling pressure has been washed out, loosens the collar and hunts for a little overnight exposure.



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the brick wall at the end of those wonderfully profitable periods because they tend to disappear as quickly as they appear.

A loose collar favors two entry-scaling techniques, when you don't choose to go all-in at once:

- Trade three to four pieces in declining size. This keeps the average entry price closer to the failure target and lets the market take you out with a smaller loss if you're proven wrong.

- Trade three to four pieces, equally sized, but only after calculating the intended average entry price and total loss you're willing to take on the position.

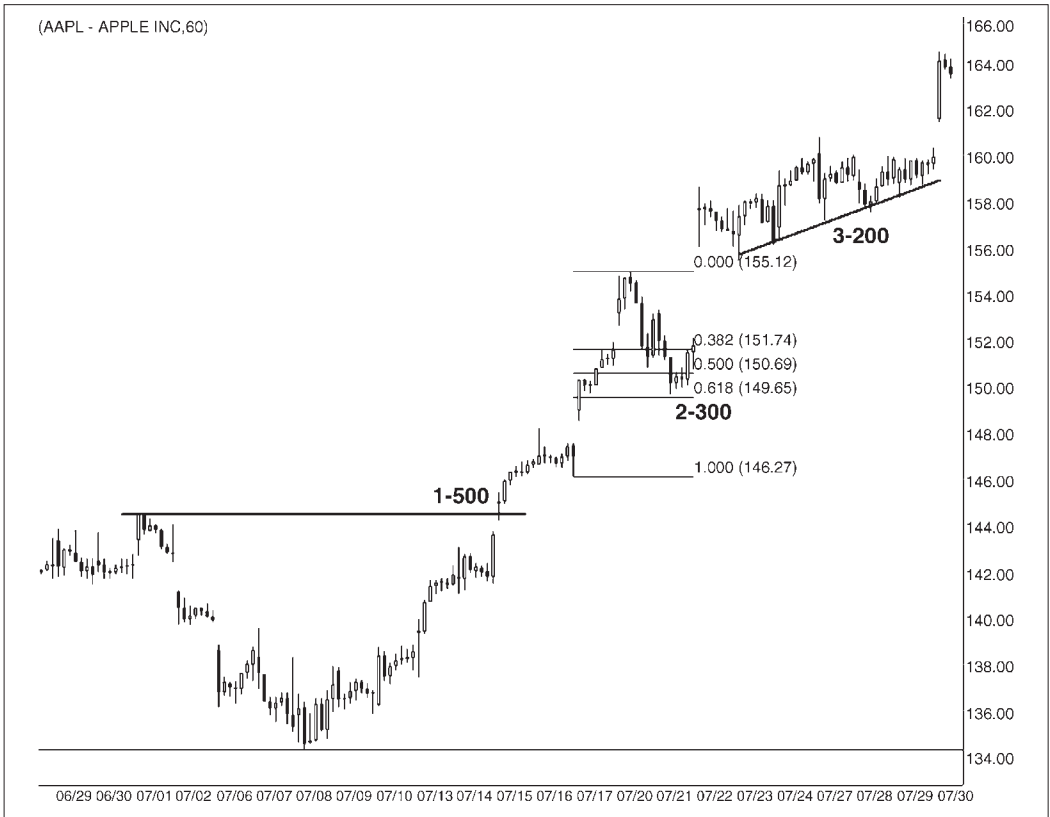
The second methodology provides less control than the first because more things can go wrong when you're trying to establish an average entry price. There are two common scenarios with an equalized strategy, depending on whether or not the market is moving when the execution process is under way. In quiet times, the instrument is likely to be jogging back and forth in a trading range. Entry scaling is relatively easy within this constricted price action because you can pick up pieces during pullbacks. However, it's best to save at least one segment of the trade for a breakout or breakdown from the range as a reward for getting the first part of the position into a profit.

It's harder to manage an equalized strategy in a moving market. Our natural tendency is to add to positions as sympathetic momentum builds, but this adversely affects the loss incurred if price turns tail and hits the failure target. A trailing stop loss will manage this added danger, but it's best to wait until the entire position is taken. In other words, rely at first on the original stop put in place after the first piece, because it matches the assumptions you've made about the average entry price. Then reexamine your exposure after adding the last piece, noting how price differs from reality, and adjust your stop loss accordingly.

Moving markets are less risky when utilizing a decreasing size strategy because you're weighting the trade in the direction of the stop loss. However, it still makes sense to avoid momentum entries and instead use smaller-scale countertrends to build position size at more advantageous prices. As usual, you'll find these pullbacks on the 15-minute or 60-minute charts, when your setup is spinning off a daily chart. In Figure 12.5, we can see how this works with Apple, which exploded higher during a broad-based summer tech rally. The initial buy signal triggers when it breaks above the two week high near 145. We buy 500 shares (1), giving us an average entry price at 145. The stock then rallies 10 points and pulls back to the 62% retracement of the buying wave, supporting a second scale. We buy 300 shares (2) at 150, raising the average entry price to 146.87. The stock bounces strongly and rallies to another high. It then starts to creep higher, carving out a 60-minute trendline. We buy another 200 shares (3) when it dips into trendline support at 157, giving us 1,000 total shares and raising our average entry price to 148.90. So, although the stock has risen 12 points since the breakout, our average entry price has risen just 3.90 points.

FIGURE 12.5

Scaling into Apple.



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The defensive collar precludes heavy exposure in adverse markets so scaling strategies are relatively simple. Limit yourself to just two pieces applied at the right time, with each segment smaller than usual in deference to the increased danger. The initial entry just follows the pattern—buying or selling narrow range, a pullback, or a momentum move. The last piece comes as a reward for services rendered. In other words, buy or sell an equal number of shares when the trade finally produces a profit. However (and this is the tough part), don't add a third piece if it continues to move in your favor, although you might be salivating like Pavlov's dog. Your defensive collar is on, preservation is the name of the game, and it makes no sense to turn a winner into a loser.

Finally, remember that cash is a position too. You'll run into historic environments that are so dangerous you need to step aside, hide in a closet, and let other traders take the risk. Of course, horrendous volatility in the fourth quarter of 2008 offers a perfect example. It was the type of market in which you could make a fortune in one hour and then lose your shirt in the next hour, especially if your risk management strategies weren't state of the art and perfectly executed.

EXIT STRATEGIES

The wisdom to "buy low and sell high" sums up our participation in the financial markets. Of course, this deceptively simple advice can be real hard to follow in the real world and in the heat of battle. Just consider how often a good-looking position has moved in your favor and then turned violently, triggering a shock loss. Of course we're absolutely stunned when this happens because, in our minds, we've already started to count the unrealized profits.

What's the right exit strategy when a position is going nowhere? Of course, all trades need time to perform, but sometimes they just flatline or lose the elasticity we were counting on to start a big rally or selloff. When that happens, we have to decide whether it's best to hang around or to move back to the sidelines and wait for another trade. It's really a question of opportunity-cost. In other words, will another position make better use of our resources, keeping in mind the capital placed into the position as well as the brainpower required to watch it from day to day, or hour to hour?

Curiously, the main reason we sit in nonperforming trades is to get payback for the energy we put into finding the opportunity in the first place. This is a losing mindset because the market doesn't care how much sweat it took to find the trade, which will either work out as expected or won't. On the flip side, we all know how it feels to dump a nonperforming position and then sit there, dumbfounded, while it takes off without us. That fear of missing out is another reason we're so reluctant to give up and head back to the sidelines. It's easy enough to overcome this phobia by starting a journal and keeping tabs on how these positions perform after you get out. The process helps tremendously because you're likely to discover you've done the right thing the vast majority of the time. However, if you find the opposite is true, take a giant step back and give your positions more room to run before pulling the plug.

Trending markets hypnotize traders, forcing them to forget the valid reasons they took their positions in the first place. The subsequent brain cramp can trigger all kinds of impulsive behavior and bad decision making when it's finally time to get out. There are three basic reasons we exit our positions: to book profits, take losses, or respond to a change in market character. Each reason demands multiple strategies to manage the unique attributes of that particular scenario. Traders need to play out these exit plans in their heads over and over again, so they take spontaneous action when the time to act arrives. This role-playing exercise is extremely important in developing effective risk management skills.

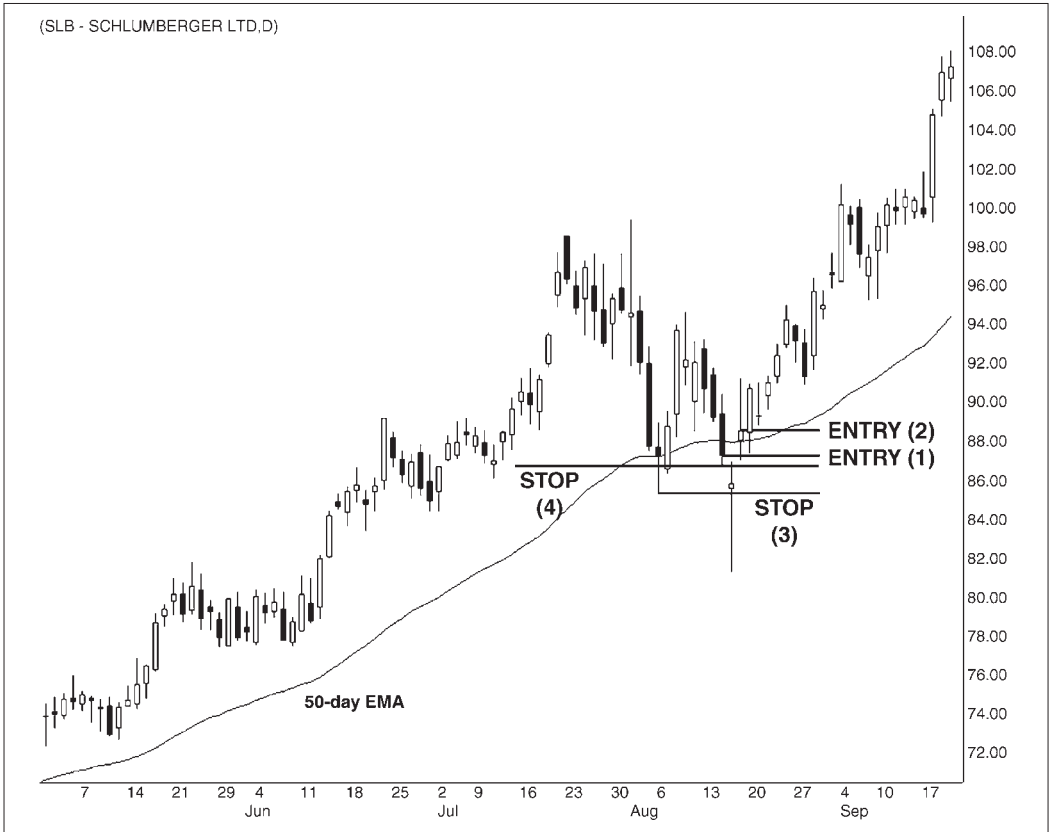
Taking a loss is the easiest of the three strategies to learn but the hardest to execute in real-time trading. Simply stated, we need to get out when we're proven wrong. In most cases, this means dumping a long position that breaks a support level you expected to hold when you did your market analysis. As noted throughout this text, the survivalist trader places the initial stop loss just behind one of these narrow levels, after measuring the impact of rinse jobs, and gets taken out of the position automatically when price hits it. Unfortunately, many folks jump into long side trades that show little or no support for many points below their entry prices. In these cases, placing a stop loss under support can be a very costly activity. As discussed in Part Five, you're forced to manage the added risk by (a) placing a percentage stop loss under the entry price, taking the loss at 2%, 5%, or 10%, depending on risk tolerance, or (b) looking at the chart in the next lower time frame and placing the stop loss under any support found on those smaller-scale patterns.

Also keep in mind that there's nothing wrong with reentering a losing trade as long as it fulfills certain risk requirements. In fact, it might be the smartest thing you can do when the instrument reverses right after you give up and head back to the sidelines. Buying a pullback into support in an uptrend, after you get shaken out of a momentum breakout, offers a perfect example of how this can happen.

In Figure 12.6, Schlumberger charges higher in a strong energy sector rally. The uptick stalls near 100 and gives way to an intermediate pullback that reaches the 50-day EMA in early August. The stock bounces for a few days and then pulls back to test support. The trader buys (1) when price sells off into the moving average, placing a stop loss (3) under the low of the first pullback, expecting a double bottom reversal. However, the stop gets hit the next day when a down gap surges through the two-week low. Price drops three more points and then shoots higher, closing in a long-legged bull hammer. The stock jumps back above the 50-day EMA just one

FIGURE 12.6

Schlumberger reentry.



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day later, triggering a failure of a failure buy signal. The trader reenters the position (2), placing a stop loss (4) under the low of the recovery bar. The bounce holds firm this time, and the primary trend resumes control, lifting price up and over the July high.

Many traders never jump back into losing positions, despite fresh entry signals, because they're licking their wounds after getting stopped out. It's difficult to execute the new trade, psychologically, because getting it wrong the first time undermines their confidence. However, the best opportunities often come right after you take an orderly loss because you weren't really wrong in the first place, just a little too early. Not surprisingly, this is a common occurrence in our modern market environment.

Taking opportune profits can be difficult as well because greed clouds awareness when it's time to pull the trigger. Simply stated, traders are market timers. This clock sensitivity demands a quick exit when price fulfills the goal visualized in the initial analysis, a.k.a. the profit target. Markets are constantly banging up against old highs, old lows, and piles of debris from past battles between bulls and bears. Prices react quickly to these pivot points, often triggering major spikes and sharp reversals. Traders gain tremendous discipline by selling blind into a profit target. This survivalist approach lets them take advantage of the crowd's excitement at the same time the odds are favoring a reversal. It also frees them from the position so they can move on to the next opportunity.

Ironically, the next trade often shows up when the instrument just dumped turns tail, retraces to a support or resistance pivot, and then issues a fresh entry signal.

As you gain experience applying your exit tactics, you discover that trends appear drawn to magnetic "hotspots" before they change direction. This pattern structure, once understood, provides a lifetime edge that lets you plan the exit in advance and resist the thrill of the moment. A perfect example is the tendency of a trending price to surge into a major support or resistance level rather than creep into it.

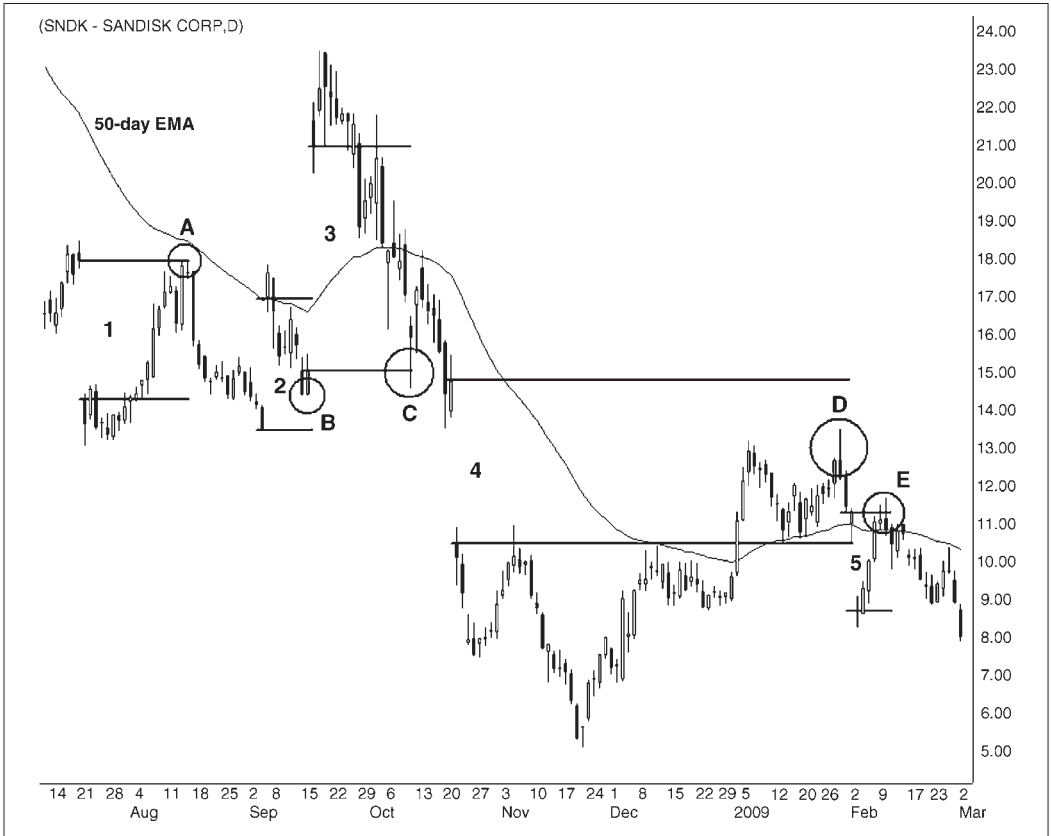
How do you protect profits in case price fails to reach the profit target or reverses ahead of schedule? The best method is to fall back on the trailing stop loss strategy as soon as the position starts to accelerate toward the profit target. You can do this in one of two ways:

- Place the trailing stop 10, 15, or 20 cents behind advancing price and keep it in place until it gets hit, or the profit target is reached.
- Set up an exit order behind the current price and watch bid-ask on the market depth screen. Hit the button when price drops 10, 15, or 20 cents off the high.

Holding period guides the profit side of the exit equation as well. Always seek the profit target that matches your time in the market. In other

FIGURE 12.7

Gap fills offer reliable price levels to take blind exits on profitable positions. SanDisk prints five notable gaps (1-2-3-4-5) over a seven-month period. The October gap (4) takes over three months to fill, while the February gap (5) takes just one week. Four of the five gaps trigger notable reversals at or close to the fill levels (A-B-D-E). Only September's big hole (3) fails to reverse completely, giving way to another downtrend. Even so, the stock still bounces over three points after filling that gap (C).



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words, trade the most profitable move from your entry to the target within the time frame you're long or short the stock, currency pair, or futures contract. This lets you apply both a time- and price-based exit strategy to your winners. The time-based exit strategy requires little interpretation. Focus on your holding period's time window rather than the price action. Exit the trade immediately when price hits the profit target at the right time. Exit the trade before price hits the profit target if the window starts

to close. The overriding goal with a time-based strategy is to find the best price available within the chosen window of opportunity.

Stocks love to fill old gaps, and they'll sometimes wait months or years to do it. With this in mind, it's sound practice to look for significant gaps the current trend might be approaching and to then exit the trade when price surges into the fill level. Afraid you'll miss a chunk of the move despite the gap barrier? If so, run a trailing stop behind the position when it fills the gap so you'll get taken out on the first reversal. However, a blind exit is always the best strategy when the gap transits a wide percentage range, because these big holes are especially hard for opposing trends to overcome and will likely trigger intermediate reversals.

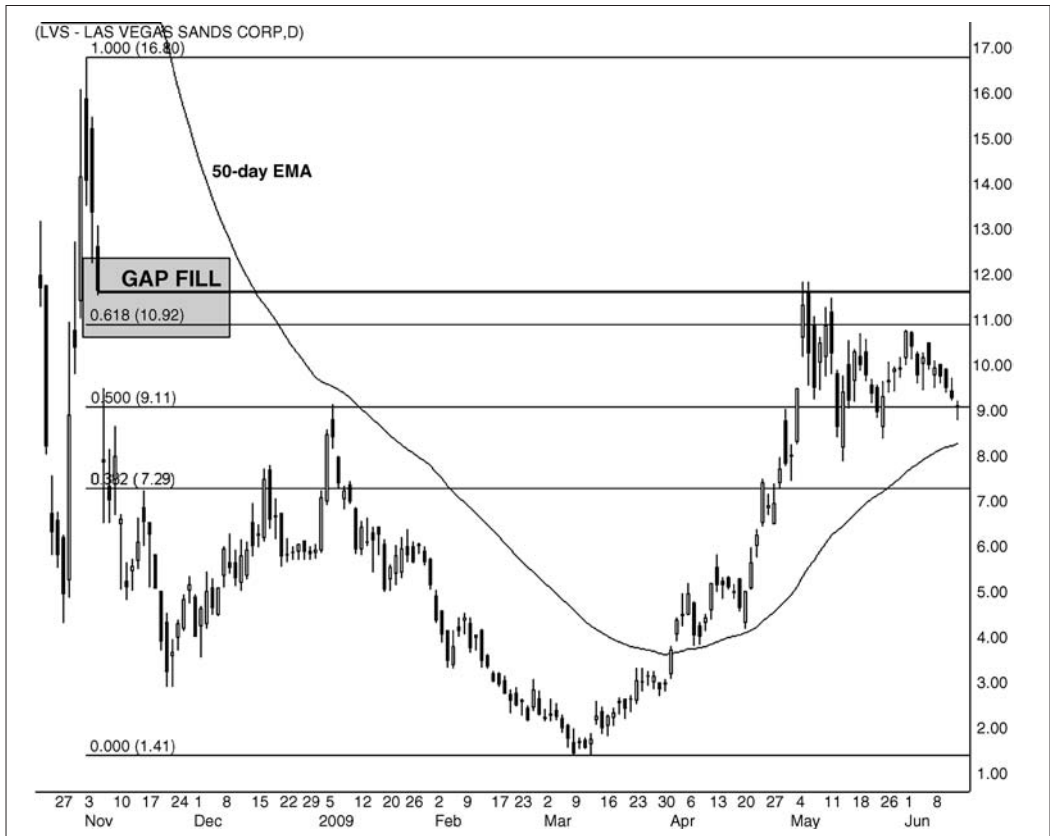
The two-phased (1-2) setup can really mess with our heads when it comes to a sound exit strategy. Here's a common scenario. We enter a long position when price rallies out of a bull flag and then realize the buying impulse will complete a cup and handle pattern as soon as it trades into the flag high. Seeing this larger-scale pattern, we fail to book the considerable profit we've earned as a result of the flag breakout in hopes of catching the C&H breakout. This is a bad strategy. A much better plan is to take profits blindly when the position hits large-scale resistance and then watch from the sidelines, treating the cup and handle as a separate opportunity requiring its own buy signal. The good news is, if the pattern falls apart, we've already taken a chunk of the evolving rally and put it into our pockets.

Rapid price bar expansion also yields great exit signals. However, it's tough psychologically because our first instinct when riding an accelerating trend is to pat ourselves on the back and to think about doubling or tripling the position. However, it makes more sense to cash out quickly because these phenomena trigger adverse technical signals (overbought, oversold, standard deviation) that can induce sharp and sometimes violent counterswings. Personally, I'd rather put that money in my pocket and thank my lucky stars rather than worry about giving back every penny on a sudden reversal.

A little Fibonacci goes a long way in finding a profitable exit as well. For example, a correction in a downtrend is often followed by a bounce that reaches 62% of the last selloff leg. This will give you a magic number to exit a long trade after buying a falling knife, but take the additional step of confirming your exit by looking for cross-verification in broken tops, filled gaps, and violated moving averages. These convergence points add predictive power to Fib levels and pinpoint where selling pressure is most likely to reexert its primary influence. Taking

FIGURE 12.8

Use Fibonacci retracement levels to exit trades after finding cross-verification through other technical tools. Las Vegas Sands recovers from a brutal bear market decline, rallying 10 points in less than two months. The rally stalls in May and reverses at the 62% selloff retracement, which also marks the exact fill level of the November 6 gap. The subsequent pullback eventually retraces more than half of the recovery rally before the uptrend finally resumes.



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profits using standard retracements and nothing else can be difficult from a psychological standpoint because “fuzzy math” is telling you to get out when you’re sitting on a profit in a rising market. However, it isn’t a huge leap of faith after you locate other barriers converging at the same price level.

Exit planning must deal with the good, the bad, and the ugly. In other words, keep a profit protection strategy to exit winning trades, a stop loss

strategy to get out of bad ones, and a fire drill in case disaster strikes. You'll need all three tactics ready to go in every trade, because anything can happen after you hit the order button. In particular, you need a detailed plan to deal with unexpected bad news or a shock event. Visualize different panic scenarios and practice your intended response over and over again in your head. A panic exit relies on common sense. Simply stated, if you can beat the rest of the crowd out of the burning theater, then act immediately. If you can't, use the pre- and postmarkets, intraday counterreactions, and scaling strategies to exit at the best available prices. Of course, the market can do anything it wants after bad news hits, and you may have no choice but to accept a large and painful loss. Take comfort in knowing that sudden and sometimes devastating losses are a cost of doing business as a trader.

FINAL THOUGHTS ON RISK MANAGEMENT

Survivalist traders know how to find good opportunities every day. When one play doesn't work out, their transition into the next one is automatic and painless because attention is focused squarely on translating ideas into profits. When it comes to trading successfully, internal process is more important than pattern recognition. Clearly, there's a ton of material sitting on the financial bookshelves about patterns, indicators, and trading systems. Unfortunately, market technicians, not working traders, write the majority of these curve-fitting tutorials. In the real world, the ticker tape rarely responds in a logical manner to the structural elements of technical analysis, so the working trader has no choice but to exercise a predefined set of internal control mechanisms, better known as risk management, that are independent of the price chart.

In truth, we can ride trends only when there are trends to ride. No, this isn't meant to sound like a Zen koan. Simply put, the majority of market players spend too much time looking for and seeing trends that don't exist. Given this limitation, taking profits after a single price thrust rather than attempting to ride a trend for five or ten points is usually the best course of action. Realistically, those bigger, juicier returns just aren't possible until the working trader overcomes two major issues. Paradoxically, these bullet points illustrate why the real issue isn't risk management at all.

First, traders get stuck in all kinds of trend relativity errors, like those discussed ad nauseam in *The Master Swing Trader*. For example, a pattern might predict the next point but be completely wrong about the next five or ten points. In fact, that's the most likely scenario because the reliability of predictions drops off a cliff as a function of time. Second and more importantly, riding trends demands a level of risk tolerance that makes most traders extremely uncomfortable. It's common sense that, in order to take five or ten points out of the market, we need to risk two to four points at a time on routine counterswings. With most members of the trading community already undercapitalized and unprofitable, this requirement is well beyond their financial or emotional capacity.

As I've noted throughout this text, taking a timely exit, whether through a stop loss or willpower, has a major role to play in effective risk management. This begs the question, "Why haven't you placed stops, mental or physical, to keep your *current* winners from turning into losers, or your *current* losers from turning into disasters?" Your failure to act reflects the biggest problem I know with risk management techniques, i.e., they do absolutely no good if you refuse to apply them. When it comes right down to it, the real secret is, there are no secrets when it comes to risk management. It's just an issue of applied discipline, rather than chasing a magical Holy Grail that doesn't exist.

To be frank, you already know exactly what needs to be done with your position choices, trade executions, and exposure profiles. It's just a question of shaking off your unconscious desire to fail, waking up from the dead, and finally doing it.

MASTERING THE SURVIVALIST TRADE

How do you know if you're making progress on the road to long-term profitability? Of course there's an obvious answer to this question—just check your financial results. There's little doubt you're doing well if you're booking consistent profits. But raw capital production might not be the best way to judge your growth because the road to profitability has many detours in which the monthly statement isn't the best measure of results. For example, skill development is far more important than short-term profits when we go through learning curves, drawdowns, and other roadblocks. So, if dollars and cents don't tell us what we need to know, what

does? To answer that question, here are 10 characteristics that reflect solid progress on the road to market mastery:

1. Money management becomes your lifeline, and your strategies start to revolve around its core. Risk control becomes a key aspect of every position. You finally accept the fact that controlling losses has a greater impact on your bottom line than chasing gains.
2. You develop your own strategies rather than relying on books, gurus, or other people's opinions. You notice how you're finding more opportunities than you have time to trade while flipping through the charts. You look forward to the trading day with a growing sense of confidence and empowerment.
3. You feel more like a student than a master of the markets. You learn new things each day and can't wait to apply them in real-life scenarios. You listen closely to everything you hear, trying to pick up hints and concepts that will improve your performance. You expand your studies into everything market-related, including economics, fundamentals, and balance sheets.
4. You stop visiting stock boards and chat rooms because they don't add anything to your performance. You realize that everyone has ulterior motives. You develop a healthy skepticism about companies, institutions, and other traders. You realize that no one is really interested in your success except you.
5. You become more private in your discussions about the market with family and friends. You understand that opinions count only when they're backed up by hard cash. You never talk about your positions or ask others what to do with them.
6. Trading starts to feel like any other successful profession. Your average profits get bigger while your losses get smaller. You experience fewer drawdowns that drain your capital and undermine your confidence. The trading day gets a little boring, but you actually prefer the lack of emotional highs and lows.
7. You grade your performance each day and recognize when actions do not meet your rising standards. You notice how certain times of the day are particularly dangerous or rewarding for your trading style. You keep a mental diary that notes your strengths and weaknesses in stark detail.
8. You never cut corners in your analysis, no matter how tired or exhilarated you feel at the end of the day. You set aside time to review your results, download fresh data, and uncover themes

for the next session. You don't trade at all when nonmarket matters keep you from finishing your nightly preparation.

9. You watch all types of markets, even those you're not trading at the time. You realize the next opportunity might come from anywhere, and you want to be prepared. You also understand your interests will change over time, so you want to be ready for the next big thing.
10. You keep detailed records and update them on a regular basis. You look at your profits and losses with complete detachment and a keen eye for self-improvement. You don't "conveniently" forget those trades you'd rather not think about.

THE REAL WORLD: THE MASTER SWING TRADER

All of your trading skills, market knowledge, and ticker tape observations can come into play at any time.

You're up with the birds and turn on your trading screen. The last two weeks haven't been a good time for the markets, with a persistent selloff following a three-month rally. You've adjusted to the weaker tape by applying a defensive collar that's keeping overnight positions to a minimum, while hunting for day trades you can flip in one, two, or three hours. Mr. Market hasn't made things any easier this morning, with an overnight selloff that's dropped the S&P 500 futures nearly 1½% and the Nasdaq-100 futures just under 1%.

The performance divergence between the index futures catches your eye immediately. You look around your screen and notice that Amazon is actually up a few cents on no news. With this in mind, you consider that a midsession recovery might start in the four letter stocks and then spread into the blue chips. You also realize that a downward thrust in the Nasdaq-100 could get it in sync with the S&P 500, end the divergence, and signal the start of a downside trend day.

A wave of program algorithms hit the index futures right at the opening bell. There are 30 stocks on your trading screen, each set to flash green on an uptick and red on a downtick. You notice how the index futures convulsions are triggering lockstep gyrations on nearly every stock you're watching, with green and red flashing to absolute perfection. This is a nearly perfect "tell" for broad program activity. With

this in mind, you employ the prime directive when dealing with ram-paging algorithms: don't fight the tape.

You stayed on the sidelines overnight, in line with your multiday defensive collar. This detachment lets you watch the early price action objectively rather than run around like a chicken with your head cut off, looking for safe exits for losing positions. Your neutrality also gives you a definable edge this morning because it will be much easier, emotionally, to take advantage of a sudden reversal.

The S&P 500 and Nasdaq-100 spent the prior session bouncing weakly at short-term support after a few down days. Those levels break at the opening bell, setting up one of two likely outcomes:

- The thrust marks the final impulse of a down wave, with gaps that get filled quickly and trap short sellers in a squeeze play.
- The thrust marks the next wave in a downtrend that drops prices to even lower levels.

You mark out the opening prices on the index futures and then sit back, doing nothing because no signals will trigger until the market finally shows its hand. It's tough to stay out of the early action, with all the flashing lights and random movement, but your discipline prevails because it's your job to make money, not enjoy the thrill of the hunt. So you take a deep breath and pay close attention, realizing the entry signal might come in minutes, hours, or never, depending on the news flow and emotional intensity of the traders looking for an edge today. Then, in a flash, things start to make sense because two economic reports are set for release at the top of the hour. The falling market, which has just broken a trading range and hit a multiday low, is positioned perfectly for a news-triggered bear trap. Rather than wait and react to the upcoming data, you start a well-rehearsed workflow that visualizes stocks and sectors that might benefit if the news goes against the grain of popular opinion.

Your investigation uncovers two interesting choices. First, rumblings about inflation have been keeping a bid under the gold futures for a few weeks, but recent data don't offer much firepower to either side of the argument. Inflation-sensitive components in the upcoming data might finally decide that argument one way or the other. The top of the hour will also bring market-moving data on retail sales. The sector has been falling off a cliff, so good news might have a limited effect, but a few mall favorites have become chat room "story stocks" that are bucking

the sector tide. You toss those issues onto your screen, just in case they catch fire after the news.

Gold is the “go-to” play when inflation is moving the market, so you pull up the gold ETF and a few sector blue chips, looking for bullish patterns that might support rallies after an inflationary number. Scanning through the charts, you can’t find good entries because a sector-wide gap, triggered by a selloff two months ago, is undermining the reward:risk equation and limiting the upside. Rather than give up, you follow your instincts and shift into the small cap universe. This effort pays off, uncovering two small gold miners that are trading near their monthly highs, with two to four points of “clear air” right overhead. With the technical planets in perfect alignment, those stocks should rally, perhaps strongly, if the precious metals group gets a lift from the news. The gold play also fits nicely into your multiday defensive collar because the sector is trading against the broad averages. That isn’t always the case, but it happens often enough that a defensive equity collar usually yields an aggressive gold and silver collar.

The economic data hit the newswires, triggering a quick buying spike on the index futures. But the up wave just carries into the prior day’s resistance levels, raising the odds for a sell-the-news reaction. Applying a contrary mindset, you put yourself into the shoes of the short selling crowd and consider what price action would force them into thinking they’re on the wrong side of the market. Those are the levels where the bear trap will be sprung, if it gets sprung at all. There’s an added benefit in the discovery process because the same levels will also act as execution triggers for the two trade setups you were contemplating this morning.

The actual news is a mixed bag for your intended strategies. There isn’t much inflation showing up in the reports, and the gold futures are responding with a big yawn. However, a mild uptick in retail sales is keeping a bid under the sector’s top ETF, which is now trading above yesterday’s low, unlike the S&P 500 or Nasdaq-100. With the modern market seeking out leadership wherever it can find it, retail becomes the sector to watch this morning, because a rally and short squeeze in that single group might force program algorithms selling the index futures to shift gears and reenter on the long side.

Meanwhile, you’ve set up buy orders on two retail story stocks that have bounced up to three-day resistance after the news. However, you’re wearing an intraday defensive collar in addition to the multiday defensive collar triggered by the broad downtrend. This short-term collar

was put into place at the open, when the index futures broke support. Applying this risk management filter, you won't execute the buy orders, even if those stocks break out, as long as the index futures stay under resistance. Your reasoning is simple: with those instruments attracting sellers and program algorithms moving the market, a retail breakout has higher than average odds to fail because basket strategies will sell entire sectors through ETFs, undermining individual components.

Your single-minded focus on anticipation instead of reaction now lets you visualize a major sentiment shift if the index futures surge above the short seller's "panic line" and trigger a bear trap. That positive event would remove the intraday defensive collar and replace it with an aggressive collar that's in sync with the rising market. This would have a twofold effect on the retail buy setups. First, it would let you buy the breakouts, if and when they happen. Second, it would open the door to early entry at resistance because the sentiment shift has greater power to trigger the retail breakouts than demand for the individual stocks. Getting on board early, before other traders get their signals, would also take advantage of a positive domino effect that flows from the index futures into the session's top-performing sectors.

The bear trap springs a few minutes later, spiking the index futures back above the prior day's lows. Your tape reading now watches for a very specific secondary reaction. Simply stated, if your thesis about panicking short sellers is correct, the initial spike above resistance should trigger a second upthrust, which confirms they're covering their positions. However, there's no need to wait before executing your first trades of the day, so you pick up a half position in each retail stock, although these stocks haven't broken out yet. Once that's accomplished, you wait for the secondary reaction and then buy the rest of the position, whether it's still stuck at resistance or already in breakout mode.

Market activity then slows through the middle of the day. You keep one eye on the index futures but shift your trade management down to the individual patterns, watching reward targets and protecting against sudden reversals. Unless the morning bear trap has shifted the broader environment from a downtrend into a sideways market or a new uptrend, your multiday defensive collar remains in place. As a result, you'll need a good reason to hold the positions overnight, regardless of their assumed profitability. There isn't one, so you refocus your efforts on taking the most money out of each trade. First, you consider how likely it is for the index futures to close near the highs in that session. Next, you look at advance/decline data for each exchange (market breadth) as

well as up:down volume. If both numbers are tweaking sharply to the plus side, you try to hold the positions as long as possible, in order to take advantage of a last hour buying surge. If not, you watch closely for a midday reversal that might print the day's high ahead of an afternoon counterswing.

One of your retail positions is pushing toward a three-day swing high, which is also sitting at a round number, while the other fills a down gap printed last week. The index futures are still grinding higher, but momentum has slowed considerably, and market internals are just moderately positive. Your inner voice speaks softly but firmly right now, telling you to take the money and run. In response, you grab two decent profits that will cover the rent but not a trip around the world.

You're not complaining, though, because you've just taken a trading day full of lemons and turned it into a glass of lemonade.

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G L O S S A R Y

abandoned baby A three-bar candlestick reversal pattern. A single bar gaps up or down but then immediately gaps back in the opposite direction on the next bar. The shadow of the lone candle never crosses the shadow of the bar before the first gap or after the second gap.

accumulation-distribution (acc-dis) The underlying buying or selling pressure within a particular stock.

Adam and Eve (A&E) Top or bottom reversal pattern noted by its sharp, volatile first high (low) and slower, rounded second high (low).

ascending triangle A common continuation pattern that forms from a rising lower trendline and a horizontal top resistance line.

avgLOSS A performance measurement that shows the total losses divided by the number of losing trades.

avgWIN A performance measurement that shows the total profits divided by the number of winning trades.

Barron's Effect Monday price action generated by bullish or bearish weekend columns in *Barron's* news magazine.

bear hug A trading strategy that finds short sale opportunities in weak markets that rally into resistance or narrow range bars on the verge of breakdown.

bear trap A negative opening that encourages bears to sell positions, followed by a **sharp reversal**.

Bollinger Bands (BB) Elastic support and resistance channels above and below price bars that respond to the tendency of price to draw back to center after strong movement in either direction. The Bollinger Band center band sets up at the moving average chosen for the indicator.

breakaway gap A classic gap popularized in *Technical Analysis of Stock Trends* (Edwards and Magee) that signals the start of a new trend after a prolonged basing period.

bucket shops Early twentieth-century stock gambling parlors that catered to short-term speculation. Fictional trader Jesse Livermore discusses his experiences in them in the classic *Reminiscences of a Stock Operator* (Lefèvre).

bull trap A positive opening that encourages bulls to buy positions, followed by a sharp reversal.

charting landscape A three-dimensional view that evaluates complex price action through multiple layers of information on a single price chart.

clear air (CA) Pockets of thin participation and ownership that often lead to wide-range price bars.

climbing the ladder Bollinger Band pattern that indicates a strong and sustained rally.

coiled spring A trading strategy that executes a position at the interface between a rangebound market and a trending market.

continuation gap A classic gap popularized in *Technical Analysis of Stock Trends* (Edwards and Magee) that signals the dynamic midpoint of an ongoing trend.

convergence-divergence (C-D) The tendency of two or more charting landscape features to confirm or refute an expected price outcome.

cross-verification (CV) The convergence of unrelated directional information at a single price level.

cross-verification × 4 (CV×4) A high probability trade in which a single price and time emerge from analysis through at least four unrelated methods.

cup and handle (C&H) A popular pattern that triggers a breakout through a triple top. The formation draws a long and deep base after an intermediate high. The market rallies into a double top failure that creates the “cup.” It pulls back in a small rounded correction that forms the “handle” and then surges to a new high.

cup and two handles (C&2H) A cup and handle variation that draws two congestion zones on the right side of the pattern before price ejects into a strong breakout.

dark cloud cover A two-bar candlestick reversal pattern. The first bar draws a tall rally candle. The next candle gaps up but closes well within the range of the prior bar.

dark pools Stealthy, off-market crossing systems used by funds and institutions to trade directly with each other, out of the public eye and away from exchange oversight.

descending triangle A common reversal pattern that forms from a descending upper trendline and a horizontal bottom support line.

dip trip A trading strategy that buys pullbacks in an active bull market.

doji A one-bar candlestick reversal pattern in which the open and close are the same (or almost the same) price, and the high-low range is above average for that market.

double bottom (DB) A common reversal pattern in which price prints a new low, reverses into a rally, and returns once to test it before moving higher.

double top (DT) A common reversal pattern in which price prints a new high, reverses into a selloff, and returns once to test it before moving lower.

Dow Theory Observations on the nature of trend by Charles Dow in the early twentieth century. Dow Theory notes that broad market trends verify when the three major market averages all move to a new high or low.

electronic communication networks (ECNs) Computer stock exchanges that rapidly match, fill, and report customer limit orders.

11 a.m. countertrend The tendency of intraday price to reverse direction about 90 minutes after the open.

Elliott five-wave rally/selloff set The completed wave structure in a primary Elliott Wave trend.

Elliott Wave Theory (EWT) A pattern-recognition technique published by Ralph Nelson Elliott in 1939 that says all markets move in five distinct waves when traveling in the direction of a primary trend and three distinct waves when moving in a correction against a primary trend.

empty zone (EZ) The interface between the end of a quiet rangebound market and the start of a new dynamic trending market.

execution target (ET) The predetermined point in price, time, and risk at which a trade entry should be considered.

execution zone (EZ) The time and price surrounding an execution target that requires undivided attention in order to decide if a trade entry is appropriate.

exhaustion gap A classic gap popularized in *Technical Analysis of Stock Trends* (Edwards and Magee) that signals the end of an active trend with one last burst of enthusiasm or fear.

expiration magnetism The tendency of stocks to gravitate toward the levels of highest open interest during options expiration week.

fade A swing trading strategy that sells at resistance and buys at support.

failure of a failure A price swing that reestablishes support or resistance after it's broken by a failed breakout or breakdown.

failure target The projected price at which a losing trade will be terminated. The price at which a trade will be proven wrong.

falling knife A stock or other financial instrument that looks attractive for purchase even though it's selling off sharply.

Farley's Accumulation-Distribution Accelerator (ADA) A technical indicator that measures the trend of accumulation-distribution.

Fibonacci (Fibs) The mathematical tendency of trends to find support at the 38%, 50%, or 62% retracement of the last dynamic move.

finger finder A trading strategy that initiates a variety of tactics based upon single bar candlestick reversals.

first rise/first failure (FR/FF) The first 100% retracement of the last dynamic price move after an extended trending market.

5-8-13 Intraday Bollinger Bands and moving average settings that align with short-term Fibonacci cycles. Set the Bollinger Bands to 13-bar and 2 standard deviations. Set the moving averages to 5-bar and 8-bar SMAs.

five-wave decline A classic selloff pattern that exhibits three sharp downtrends and two weak bear rallies.

flags Small continuation pattern that prints against the direction of the primary trend.

foot in floor Bollinger Band pattern that indicates short-term support and reversal.

fractals Small-scale predictive patterns that repeat themselves at larger and larger intervals on the price chart.

gap echo A gap that breaks through the same level as a recent one in the opposite direction.

hammer A one-bar candlestick reversal pattern in which the open-close range is much smaller than a high-low range that prints well above average for that market. The real body must sit at one extreme of the high-low range to form a hammer.

harami A one-bar candlestick reversal pattern in which the open-close range is much smaller than the high-low range and sits within the real body of a tall prior bar.

hard right edge The location where the next bar will print on the price chart—i.e., the spot where the swing trader must predict the future.

head and shoulders This classic reversal pattern forms from an extended high that sits between two lower highs. Three relative lows beneath the three highs connect at a trendline known as the neckline. Popular opinion expects a major selloff when the neckline breaks.

head in ceiling Bollinger Band pattern that indicates short-term resistance and reversal.

historical volatility The range of price movement over an extended period of time as compared to current activity.

hole in the wall A sharp down gap that immediately follows a major rally.

inside day A price bar that prints a lower high and higher low than the bar that precedes it.

inverse head and shoulders This classic reversal pattern forms from an extended low that sits between two higher lows. Three relative highs above the three lows connect at a trendline known as the neckline. Popular opinion expects a major rally when the neckline breaks.

January Effect The tendency for stocks to recover in January after end-of-year, tax-related selling has completed.

Market Volatility Index (VIX) A classic volatility indicator used directly by the options markets and indirectly by the equity markets as a leading indicator of price direction.

Max Pain The tendency of an optionable instrument to gravitate toward the price that causes the most options positions to expire worthless.

mesa top A double top reversal pattern that declines at the same angle as the initial rally.

Moving Average Convergence-Divergence (MACD) A trend-following indicator that tracks two exponentially smoothed moving averages above and below a zero line.

moving average crossover The point at which a moving average intersects with another moving average or with price.

moving average ribbons (MARs) Wide bands of mathematically related and color-coded moving averages.

narrow range bar (NR) A price bar with a smaller high-low range as compared to the prior bar's high-low range.

narrowest range of the last seven bars (NR7) A low volatility time-price convergence that often precedes a major price expansion. A price bar with a smaller high-low range as compared to the prior six bars' high-low ranges.

NR7-2 The second NR7 in a row. A low volatility time-price convergence that often precedes a major price expansion.

neckline A trendline drawn under the support of a head and shoulders pattern over the resistance of an inverse head and shoulders pattern.

negative feedback Directionless price action in which bars move back and forth between well-defined boundaries.

noise Price and volume fluctuations that confuse interpretation of market direction.

On Balance Volume (OBV) A volume indicator that measures the progress of accumulation-distribution.

opening price principle A tendency in the futures markets for the opening price to act as support or resistance for the entire session.

oscillator A subset of technical indicators that accurately measures flat market conditions by assigning overbought and oversold price levels.

overbought The evolution of price action to a state in which it runs out of buying pressure.

oversold The evolution of price action to a state in which it runs out of selling pressure.

pattern analysis Price prediction through interpretation of the crowd behavior seen in repeating chart formations.

pattern cycles The tendency of markets to repeat identical price formations through different stages of development in all time frames. The master market blueprint that generates all chart patterns.

pennants Small continuation patterns that print against the direction of the primary trend.

%WIN A performance measurement that shows the total number of winners divided by the total number of trades.

positive feedback Directional price action in which bars gather momentum and move from one level to the next.

power spike A trading strategy that seeks high-volume events and executes positions to capitalize on their special characteristics.

profit target The projected price at which a successful trade will be terminated. The price at which a trade faces first resistance.

Random Walk Classic theory that chaos drives all market activity and that price movement cannot be predicted.

rectangle Small continuation pattern that prints sideways to the primary trend.

reflection A two-four-bar candlestick pattern that first prints a significant reversal and then thrusts away from that formation and immediately draws an identical reversal in the opposite direction.

Relative Strength Index A technical indicator that measures a stock's ability to close up rather than down for a specific period of time. An oscillator invented by J. Welles Wilder that measures overbought, oversold, and divergent market situations.

ribbon crossover A horizontal support and resistance zone created by a moving average crossover.

rinse job An intraday shakeout in which price surges above resistance or below support, triggering the stops at those levels, and then changes direction, closing back within congestion. Similar to *stop gunning*.

rising wedge Reversal pattern that slowly rises in an uptrend until price suddenly ejects into a selloff.

Santa rally The tendency of stocks to move higher in December, in a year-end event that marks up institutional portfolios.

seasonality The predictable appearance of certain market characteristics that reflect specific and repeating calendar events.

setup A sequence of bars, patterns, or other charting landscape features that predict the direction and timing of future price movement.

Seven-bells Seven price patterns with specific characteristics that support targeted trade entry.

shooting star A one- to three-bar candlestick reversal pattern with a small real body and tall shadow that pushes into an intermediate high or low before a sudden change in direction.

signpost Point on the charting landscape that identifies an imminent trading opportunity.

silent alarm A rare high-volume signal that prints a narrow-range bar and flags an impending breakout.

6-18 swing A moving average crossover system used to track intraday buying and selling pressure.

slippage The difference between expected transaction costs and actual transaction costs.

slippery slope Bollinger Band pattern that indicates a sustained decline.

standard deviation (std dev, SD) The positive square root of the expected value of the square of the difference between a random variable and its mean.

Stochastics An overbought-oversold oscillator that compares the current bar to a preset selection of high and low prices. The indicator plots the results on a graph between 0 and 100.

stop gunning An intraday shakeout in which price surges above resistance or below support, triggering the stops at those levels, and then changes direction, closing back within congestion. Similar to a *rinse job*.

support-resistance (S/R) Horizontal and nonhorizontal barriers that current price should not pass without the application of sufficient directional force.

swing trading A complex execution strategy that relies on identification of market opportunity through the charting landscape.

symmetrical triangle A common pattern formed from a descending and rising trendline. The formation has an equal bias of breaking out in either direction.

tax loss selling The tendency for selling pressure to pick up in October, when funds take losses on losing positions, ahead of the October 31 close of their fiscal years.

technical analysis Market prediction that studies crowd behavior through evolving price and volume activity.

third of a third The middle wave and most dynamic price movement within a complete Elliott five-wave rally or decline.

3rd watch A trading strategy that executes a long position on a triple top breakout.

trend mirrors (TM) Past chart activity that influences the direction and development of current trend and range.

trend relativity error A common mistake committed when a trader prepares an analysis in one time frame but executes in another.

trendlet Small pocket of chart activity that appears and disappears over time.

trendline A line that connects a series of highs or lows. The trendline can represent support in an uptrend or resistance in a downtrend. Horizontal trendlines mark support-resistance and rangebound conditions.

triangles A related set of common three-sided congestion patterns.

turnaround Tuesday The tendency of the equity markets to reverse the direction of Monday's primary trend.

wave Sustained price movement in one direction marked by clear high and low reversal boundaries.

whipsaw Erratic price behavior that triggers false signals and incurs trading losses.

window dressing Institutional buying or selling near the end of a month, quarter, or year that makes reported results appear better than actual results.

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A B O U T T H E A U T H O R

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