# ADVANCED TECHNICAL ANALYSIS OF ETFs

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# ADVANCED TECHNICAL ANALYSIS OF ETFs

## Strategies and Market Psychology for Serious Traders

**Deron Wagner**
**Edward Balog**

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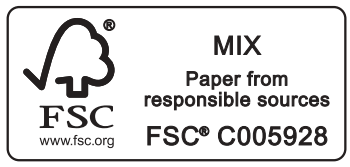

*For my adorable wife and two children—Bee, Ben, and Ocean. Your continual encouragement and positive attitudes always keep me going! So proud of all three of you.*

*—Deron*

*All my love and thanks to my family—Lori, your patience will earn you sainthood. Emily, my sweet plum pie—Go Villanova! Jack, my budding entrepreneur.*

*—Edward*

# Contents

# Foreword

When I first met Deron Wagner in 1998, I was searching for a professional trader who could help me coauthor my second book on long-term day trading. After interviewing dozens of traders, I chose Deron, not only because of his knowledge, but because he could write so well. As it turned out, I was right about his trading and writing abilities. Since those early days, Deron has written numerous articles and books, including his most recent. It's really remarkable how much he's achieved since then, particularly in his field of expertise, exchange-traded funds (ETFs).

Deron is an expert on ETFs and over the years has developed a number of unique strategies, which you'll read about in this book. He has been in the trading trenches and learned from some of the best. Deron has also made mistakes along the way, which made him tougher and more disciplined. It was Deron who taught me how psychology is the key to a trader's success. He also said to keep it simple. Anyone who reads his latest book should be impressed.

Deron has also been a longtime proponent of technical analysis, which he successfully applied to ETFs. He was one of the first to use technical analysis on ETFs, and at the time, it was a unique idea. When ETFs were first introduced, Deron eagerly learned everything he could about this intriguing security.

So when I heard that Deron was writing another book, *Advanced Technical Analysis of ETFs: Strategies and Market Psychology for Serious Traders*, I was eager to get a copy, and I was not disappointed. Deron delves into advanced strategies, which should whet the appetite of experienced (and even not-so-experienced) traders. If you want to take your ETF trading to the next level, this book should meet your needs. Even more exciting, Deron's strategies can be applied to individual stocks as well as ETFs, so there is something for everyone.

Whether he is writing about market psychology, ETF strategies, or technical analysis, Deron explains the concepts in a friendly, conversational tone that should keep you entertained and educated. No matter what your skill level, there is something new to learn. Based on my work with Deron, and the fact that we are also friends, I strongly recommend his latest book. If you want to expand your knowledge about ETF strategies, you have come to the right place.

Most important, in a fast-paced market environment, serious traders need every available tool to survive. Based on Deron's experience and knowledge, his book should help give both novice and advanced traders an edge. As Deron might say, good trading to you!

MICHAEL SINCERE*
May 2012

*Michael Sincere is a featured columnist for Marketwatch.com and the author of *Understanding Stocks* (McGraw-Hill, 2003), *Understanding Options* (McGraw-Hill, 2006), *Start Day Trading Now* (Adams Media, 2011), and *All About Market Indicators* (McGraw-Hill, 2011).

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I also wish to express my sincere appreciation for the support of all subscribers to *The Wagner Daily*, our nightly ETF and stock swing trading newsletter. It's your ongoing enthusiasm that keeps me excited to share my knowledge over the years.

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Finally, thanks to the entire team at Wiley for their hard work at pulling this all together!

DERON WAGNER
May 2012

Thanks to all of the following people who have been supportive and instrumental in my quest to author my first book.

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EDWARD BALOG
May 2012

*Advanced Technical Analysis of Etfs: Strategies and Market Psychology for Serious Traders*
by Deron Wagner, Edward Balog


# PART I

# Introduction

# CHAPTER 1

# Some Things Have Changed, but More Has Stayed the Same

Since the publication of our last book in 2008 (*Trading ETFs: Gaining an Edge with Technical Analysis)*, many things have changed in the world of exchange-traded products. Not surprisingly, some of the less popular exchange-traded fund (ETF) families have ceased operations altogether, while a handful of fresh players have stepped in to take their place. In addition to traditional ETFs, investors now have the ability to buy and sell newer offerings known as exchange-traded notes (ETNs) and exchange-traded commodities (ETCs) as well.

Collectively, these three different types of fund offerings are generally referred to as "exchange-traded products (ETPs)," but for the sake of simplicity, we will continue to refer to the collective group of ETPs as ETFs throughout this book.

Despite the several hundred new ETFs that have been launched in recent years, bringing the total number of exchange-traded offerings to more than 1,000, approximately *half* of the total ETF asset base in the United States remains parked in *less than 30 different ETFs*. In this regard, there have been a significant number of changes in recent years, but not as much has changed as would initially appear on the surface.

More importantly, one other key element has not changed—the effectiveness of tried-and-true technical analysis strategies on ETFs. The same indicators and strategies we were using to trade ETFs back in 2008 are equally as effective today, just as they have been since beginning our trading careers. This is because technical analysis is nothing more than a graphical way to measure the levels of the various human emotions driving the markets at any given time. Although technology has evolved at breakneck speed in our current lifetimes, raw and basic human emotions have essentially remained the same since the dawn of humanity. That's why the same technical analysis strategies continue to work generation after generation, regardless of the instrument traded, and regardless of location in the world. We will dive more thoroughly into this in the chapters in Part IV, "Mastering the Psychology of Trading," later in the book.

## What Can I Expect in This Book?

In our first ETF book, *Trading ETFs: Gaining an Edge with Technical Analysis*, we focused on the use of very basic technical indicators including trend lines, moving averages, support and resistance levels, volume, and price action (swing highs and swing lows). Although it is not necessary, you may find it useful to read that book because it lays the groundwork for the advanced technical strategies covered in this book.

In this follow-up book, we will introduce several new technical indicators and strategies that enhance the effectiveness of our proven "top-down" trading strategy detailed in the last book. While the merits of our initial top-down strategy can certainly stand alone, applying additional technical indicators, strategies, and concepts only serves to improve the profitability of ETF traders.

Specifically, we will introduce and focus primarily on candlestick patterns, Fibonacci levels and Fibonacci time series, and accumulation-distribution combined with the Relative Strength Index (RSI). Although we believe in the simplicity of our core trading strategy, we have found these technical indicators to be quite useful without being cumbersome. There is a balance between simplicity and using additional technical tools to enhance your trading performance.

After detailing the new technical analysis strategies, we then walk you through the outcomes of 30 different actual ETF trades that were provided to subscribers of *The Wagner Daily* newsletter. Of these 30 trades, we have chosen 20 winning and 10 losing trades because obviously not every trade is a winner. Knowing how, when, and why to exit a losing trade is a critical skill for any serious trader of the markets. The analysis and explanation of these actual trades will follow the format of the actual trades detailed in our last book, which many readers have told us was their favorite part of the previous book.

Upon presenting the new technical analysis indicators and strategies and demonstrating their application with actual past trades, we then proceed to an entire chapter dedicated to mastering the psychology of trading. Hundreds of books have been written about trading strategies, but very few of them spend much time on the psychology of trading, which we strongly believe is one of the most important, yet often overlooked, elements of being a consistently profitable and successful trader of ETFs, stocks, commodities, futures, or any other instrument. Of the few books we have seen that actually are dedicated exclusively to trading psychology, the deep concepts may be overkill or the authors fail to draw the critical connections between the individual trader and interaction with the "group." These books are usually too esoteric and lack the explanation of what is really driving the markets. In Chapters 8 and 9 of Part IV, "Mastering the Psychology of Trading," we provide you with just the right amount of crucial details explained in a user-friendly and easy to comprehend manner.

Finally, we will conclude with an update on the latest developments in ETF trading. In addition to explaining the newer types of ETPs, such as ETNs, we will also address special account considerations for these instruments that investors and traders are typically not made aware of. Admittedly, understanding accounting

and tax considerations may sound a bit boring, but understanding key financial implications of trading certain ETPs is another piece of the puzzle that impacts the overall profitability of your bottom line in ETF trading.

## Let's Rewind

Before diving into the advanced technical analysis and strategies, we must first provide a brief recap of the top-down trading strategy taught in our first book, *Trading ETFs: Gaining an Edge with Technical Analysis*, because the framework of this entire book is predicated on our top-down methodology. However, before you can implement our strategy, you must first select a trading time frame that best suits your personal preference. Only then will you be able to implement the system.

Every trader is faced with decision of determining which trading strategy and time frame best fits his or her individual style. A preliminary requirement for using our top-down method is to first identify your preferred time interval for trading. The preferred trading time frame is important because it is used as a point of reference to determine the interval of the trend you should be following. For instance, if you are a day trader (opening and closing positions intraday), the five-year trend in an ETF plays no role in your intraday trade selection or decisions. Conversely, a traditional "buy and hold" investor who holds positions for multiple years should not care at all about intraday price movements on a 5-minute or 60-minute chart.

The beauty of our ETF trading strategy is that it works equally well for all time intervals. Examples throughout this book will focus on the "swing trading" time frame because that is what we personally utilize in investing client funds in our Managed Account program, and with the detailed ETF and stock trade picks we provide to subscribers of *The Wagner Daily* newsletter. However, there are four different time periods to choose from, and the pros and cons of each time frame are discussed below. Again, our preference is swing trading, but this methodology works equally well with any of the following time frames.

## Four Trading Time Frames (Intervals) for Investors

There are basically four trading strategies employed by the majority of investors. They include the traditional buy and hold strategy, position trading, swing trading, and day trading. Following is a basic review of each of these strategies.

### 1. Traditional "Buy and Hold"

The buy and hold strategy is probably the most common investment strategy. The characteristics of this strategy include the following:

- Holding period of several years to decades.
- Focuses on following trends on long-term weekly and monthly charts.

- Typically consists of a balanced portfolio of 20 or more stocks.
- Usually based primarily on fundamental analysis, rather than technical analysis.

**Pros**

- Very passive, minimal work required once investment selection is made.

**Cons**

- Limited flexibility. When positions are entered, they are held for years or even decades.
- Potentially large equity drawdowns and acceptance of long periods of time in which there may be little or no portfolio appreciation.
- Dependent on long-term market movements and the assumption that the market will always move higher over the long term.
- Little or no consideration of current trend when entering a position.

### 2. Position Trading

Position trading is not as well known as the buy and hold strategy. It is a trend-following strategy that seeks to derive profits over relatively long time periods, but while seeking to avoid the potential major drawdowns associated with long-term buy and hold investing. It is defined by the following characteristics:

- Holding period of several months to several years.
- Narrow portfolio selection with more heavily concentrated positions.

**Pros**

- Designed to achieve big gains from riding strong trends over intermediate time frames.
- Market exposure may be reduced when drawdowns result in long- and intermediate-trend reversals in the broad market.

**Cons**

- Moderate flexibility in terms of entering and exiting positions.
- Larger drawdowns in choppy or range-bound markets.
- High volatility swings in profit and loss (P&L).

### 3. Swing Trading (Near and Intermediate Term)

Swing trading is the preferred methodology upon which our strategy is based. This strategy allows for potentially large gains with limited risk from overnight exposure, since holding periods are shorter. Here are the characteristics:

- Holding period:
  - Near-term trades are several days to weeks. Intermediate-term trades range from one to six months.
- Flexible, well-balanced strategy with solid reward-risk characteristics.

**Pros**

- Strong risk control due to market timing. Limited market exposure.
- Flexibility. Provides the ability to take advantage of shorter-term trends in both uptrending and downtrending environments.
- Offers trading opportunities in trendless (range-bound) environments.

**Cons**

- Requires active trade management. Positions must be monitored and adjusted every several days to several weeks. It is a more time-consuming, active strategy.
- Requires solid understanding and implementation of market-timing skills.

### 4. Day Trading

As the name implies, day trading is based on the intraday buying and selling of securities:

- Holding period ranges from several minutes to a full day. When "in the money," day trades are sometimes held overnight.
- Takes advantage of intraday price and volume momentum in the markets.

**Pros**

- Extremely risk-averse strategy due to no overnight exposure and risk of outside events.

**Cons**

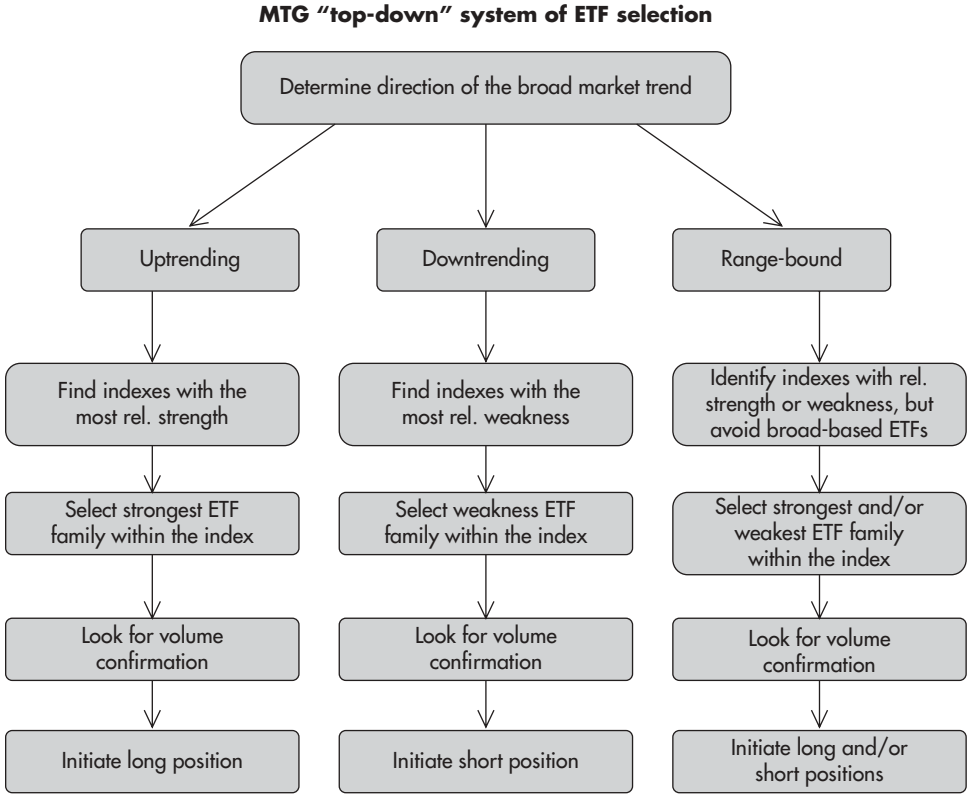
- Requires very active management, sitting in front of a monitor all day.
- Physically and mentally demanding (requires solid reflexes).
- Quite time consuming; only suitable for full-time traders.

With the above information, we have provided you with an objective overview of each of the four main time frames for trading and investing. If you already have a preferred time frame for investing, there is no reason to change it. But if you're just getting started in the markets, it's important to make the personal decision as to which trading time frame best suits your needs.

## Recap of Our Top-down Strategy

The following is a basic summary of our top-down strategy for selecting ETFs, which was detailed in the previously mentioned book. Our top-down trading approach is highly effective, yet rather simple. Many trading systems seek complexity, but we have found that the more complex trading systems become, the more difficult they are to monitor and manage. The relative simplicity of our logical strategy is illustrated in Figure 1.1.

**FIGURE 1.1** Overview of top-down strategy




*Source:* Morpheus Trading Group

**Step 1: Determine the direction of the broad market trend.**

- If the main stock market indexes (S&P 500, Nasdaq, and Dow Jones Industrial Average) are trending steadily higher, nearly any type of ETF with relative strength to the broad market can be traded.
- If the major indexes are in a steady downtrend, seek out any ETFs with relative weakness to the broad market.
- If the major indexes are range-bound, avoid trading in broad-based ETFs that track the major indexes.

**Step 2: Determine which individual indexes are showing the most relative strength or weakness (divergence) to the main stock market indexes.**

- Compare the charts of industry-sector indexes and specialty ETFs with the S&P 500 or Nasdaq Composite Index (the Dow is too narrow-based).
- Buy ETFs in the sectors or indexes with the most relative strength if the market is uptrending overall.
- Sell short ETFs in the sectors or indexes with the most relative weakness if the market is downtrending overall.

As an alternative to the graphical method of looking at charts, use numerical percentage-change market minders to identify relative strength or weakness.

**Step 3: Compare all the ETF families within the specific index to find the individual ETF with the most strength (or weakness) relative to the corresponding index.**

- Again, overlay charts of each ETF family with the corresponding sector index.
- Ensure that the ETF is also showing relative strength (or weakness) to itself, closing in the upper 30 percent (or bottom 30 percent) of its intraday range every day.
- Monitor changes in volume to confirm institutional buying interest.

**Step 4: Select the resulting long or short ETF position now most likely to outperform the market.**

**Step 5: Find the proper timing for a new position entry in the ETF most likely to outperform the stock market.**

- Use the strategies in this book to locate ideal technical entry and exit points for new ETF trades, then exit with maximum profitability or minimal loss.
- Know how to manage overnight gaps in your positions.
- Trail stops based on trend lines and other technical indicators for maximum profitability and conservation of profits.

In this book, we will build on the concepts taught in the five basic steps to our "top-down" strategy summarized above by introducing additional indicators to improve your overall market timing, new technical trade "setups," and key rules for successful understanding of the psychology of trading.

*Advanced Technical Analysis of Etfs: Strategies and Market Psychology for Serious Traders*
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# CHAPTER 2

# Complete Synopsis of the ETF Swing Trading Strategy

Now that we have defined the basic characteristics of the top-down trading strategy, let's take a look at other components that are critical to any trading strategy. A trading strategy alone will *not* make you a successful trader. You must also have a core trading philosophy and a trading plan that establishes a strict set of rules by which you implement and manage the strategy. Further, you must constantly educate yourself and monitor your trading activity to ensure that you are consistently following your trading rules. A trade journal is often used as a feedback mechanism. Finally, you must thoroughly understand market structure (group behavior) and become a master of individual trading psychology.

## Core Investing Beliefs

Core investing beliefs are the trading rules and philosophy that guide us through our top-down trading strategy. Think of core beliefs as a set of trading rules that guide all trading decisions and behavior. Core beliefs allow you to react quickly when market opportunities and threats present themselves. They are what keep you mentally "centered" as a trader, as they are intended to remove unproductive emotions (individual psychological barriers) from trading decisions. Once they are established, selecting an investing style becomes a simple process. It's important to find a style that doesn't force you to compromise your beliefs or put you in an uncomfortable state of mind. For instance, some individuals are just not suited for day trading, as it requires quick recognition and timing, and it can be quite stressful. On the other hand, there are traders who cannot deal with major drawdowns to their portfolios. Therefore, such individuals may not have the patience or tolerance for a buy and hold strategy.

## Why Swing Trading? Trading with the Trend!

In our opinion, swing trading in the short- to intermediate-term time frame is the best-fit strategy for many traders. We believe the swing trading time frame provides the maximum potential for profits, while putting capital at the least amount of risk and not violating any of our core beliefs.

If managed properly, trading with the intermediate-term trend increases the odds of success, because both the market and individual ETFs are trending in unison. Positions are only entered when the trend of the ETF coincides with the broad market trend (this is where our disciplined market timing rules come into effect). Simply put, we firmly believe that momentum-based strategies work! This interval of trading also fits our psychological profile.

It has been well documented, and our research supports the premise, that stocks in strong uptrends, which have outperformed the market over a six- to 12-month period, have a high probability of continuing the trend over the next several months. Think of it in terms of "an object in motion tends to stay in motion." Trends don't reverse without a fight.

Stocks trading near 52-week highs have the least amount of overhead resistance to work through and therefore can remain in uptrends far beyond typical trader expectations. In uptrends, swing trading involves the purchase of stocks that are trading within 20 percent of their 52-week high. Ideally, the best candidates will be trading at 52-week highs *and* new all-time highs. Stocks at all-time highs have no established resistance to work through. The only resistance they face is that which is imposed on them by the market (the group).

Cheap ETFs and stocks are cheap for a reason. Our strategy avoids "bargain hunting," which is a trading methodology that involves buying stocks that have fallen out of favor among institutional investors. The thought process behind bargain hunting is to simply buy the lows and sell higher. However, although it is human nature to think in terms of buying stocks that appear to be trading at a bargain, this strategy is wrought with risk because market trends usually last significantly longer than traders expect. To purchase downtrending stocks in an uptrending market involves fighting the trend. The crowd generally wins, and the market is the crowd. As stated by the famous economist and speculator John Maynard Keynes, "the market can remain irrational longer than you can remain solvent."

In contrast to the bargain-hunting strategy, our approach is predicated on *buying high and selling higher*. Strong stocks are strong for a reason . . . they are being accumulated by large institutional investors such as banks, mutual funds, and hedge funds. When the big boys want in (or out), it is not prudent to get in their way because more than 50 percent of the stock market's average daily volume is the result of institutional trading activity. As such, we feel the proper way to invest is with the momentum of the trend—buy high and sell higher! This is one of our core beliefs. Again, human nature is to underestimate how long a trend can last, but successful trading and investing goes against the psychology of human nature.

*These same principles hold true when both the market and individual ETFs are downtrending*. It makes little sense to sell short ETFs that are consolidating above key moving averages during a downtrend. Shorting ETFs that are showing bullish divergence to the broad market is not sensible because if the market makes a sudden reversal higher, they will be the first ETFs to rally. However, once an ETF has broken below its 20-day, 50-day, and 200-day moving averages, *and* the broad market is downtrending, the momentum is in your favor.

## Risk Control Is Everything!

Before entering a trade, you must consider the risk involved in the position. Therefore, we never execute a trade without predefining the position size, trigger price (entry price), and stop loss. Placing protective stops and honoring them on *every single trade* is paramount to your success. Ignoring stops and becoming emotionally attached to positions is the quickest path to financial ruin.

## Market and Trade Structure (Trade Setups)

When evaluating potential long or short trades, we look to identify particular trade patterns (setups) that have historically resulted in the highest percentage of winning trades. We also refer to trade structure as "trade setups." We will elaborate more on the concept of trade setups later in this chapter.

## Overview of the Technical Strategy

Now that you have a basic understanding of our core beliefs, we will introduce you to the Morpheus Trading Group technical trading strategy. As discussed, our strategy falls under the category of swing trading. We use intermediate-term trend analysis, which fits our personality profile and, in our opinion, allows us the ability to maximize our profit potential with the least amount of risk exposure to the market. Everything we do starts with risk management, which determines the reward-risk ratio of our trades. We only look to enter trades that provide at least a 2 to 1 reward-risk ratio, based upon very specifically defined trade setups and trading rules. A reward-risk ratio tells us how much we are risking on the trade, compared to the projected profits. For example, if a trade has a projected gain of 4 points until the next significant resistance level, while requiring a 2-point stop loss based on our technical chart pattern, the reward-risk ratio would be 2 to 1.

## Five Steps to Becoming a Master Trader

Our core beliefs are that there are five steps to becoming a master trader. We have listed the steps below, and we will summarize and illustrate each of the steps throughout the remainder of this chapter:

1. Identify the broad market trend (with daily and weekly charts).
2. Identify proper trade setups.
3. Have a clearly defined exit strategy.
4. Have a disciplined money management strategy.
5. Understand the psychology of trading.

### 1. Identify the Broad Market Trend (with Daily and Weekly Charts)

Identifying the predominant broad market trend is a fairly straightforward process. As a general rule, it is always better to buy ETFs that are trading above three common moving averages: 20-day exponential moving average, 50-day moving average, and 200-day moving average. Further, all three moving averages should be sloping higher, as that indicates the trend has already been in place for a substantial period of time. Based on the simple usage of these three moving averages, you can quickly and easily determine whether or not a valid trend is in place. Figures 2.1 and 2.2 illustrate our concise and easy to understand methodology for determining if an uptrend is in place. Figure 2.1 shows a trend in the S&P 500 SPDR (ticker symbol:SPY), a common proxy for the broad market, that meets our basic criteria. Figure 2.2 shows an ETF that is trying to establish a new uptrend, but has not yet met our requirements.

Figure 2.1 is the commonplace "daily" chart interval for looking at trends. However, we frequently use the longer-term "weekly" chart interval to eliminate some of the "noise" and to get a clearer picture of the actual trend. This is shown in the weekly chart of SPY in Figure 2.1a.

Fast-forwarding several months of the same ETF shown in Figure 2.2, we notice in Figure 2.3 that the uptrend eventually becomes established, based on our criteria. When no clear trend is in place, patience and discipline to wait on the sidelines, or at least significantly reduce share size on all new trades, should be one of your main focuses. Otherwise, it can lead to rapidly "churning" your brokerage account.

By making sure both the main stock market indexes and your ETF are trending in the same direction, you increase your odds of success. As such, we focus on trading in the direction of the predominant market trend. Figure 2.4 provides an excellent example of trading an ETF that is not only moving higher with the broad market, but also has *relative strength* to the broad market. Notice how the SPDR Gold Trust ETF (ticker symbol: GLD) set a new high, but the benchmark S&P 500 Index did not. However, an ETF that is trending higher when the main stock market indexes are clearly downtrending (rather than consolidating in a sideways range) will experience much more difficulty moving higher, since it is fighting the trend of the broad market

**FIGURE 2.1** Uptrend in place (daily chart)


**FIGURE 2.1a** Uptrend in place (weekly chart)

**FIGURE 2.2** Uptrend not confirmed


**FIGURE 2.3** Uptrend eventually becomes confirmed

**FIGURE 2.4** Trade with the market trend


The next three charts (Figures 2.5 to 2.7) emphasize the power and duration of strong trends. Any attempts to sell short, for example, would have resulted in disaster. Simply put, momentum-based strategies work! The longer a dominant trend has been in place, the more likely the trend is to continue in the near-term.

Trend trading requires that you are not afraid to buy at 52-week highs, as trades are breaking out. This is why we *buy breakouts to new highs when the broad market is also trending steadily higher*. Notice on the monthly charts in Figures 2.8 and 2.9 that once the valid breakout to a new high occurs, it can last for *many* months. When you buy at the highs, by definition, there are no existing resistance levels to contend with, and it is therefore much easier for the trade to go higher. Also in Figure 2.8, notice how the ETF initially retraced lower to test support of the breakout level immediately after breaking out to a new high. This commonly occurs, but a successful test of new support of the breakout (which was prior resistance) typically sets the ETF in motion, sending it much higher in subsequent months.

Figure 2.9a is a daily chart of iPath Goldman Sachs Crude ETN (ticker symbol: OIL) that summarizes our general methodology of "buying high and selling higher."

## 2. Identify Proper Trade Setups

A "buy setup" refers to an ETF that has met all of our technical buy criteria and has a high probability of resuming its uptrend within the next few days. To identify such a setup, we must first locate a proper basing formation.

**FIGURE 2.5** The power and duration of trends (example 1)


**FIGURE 2.6** The power and duration of trends (example 2)

**FIGURE 2.7** The power and duration of trends (example 3)


**FIGURE 2.8** Buy breakouts to new highs during a strong trend

**FIGURE 2.9** Buy breakouts to new highs during a strong trend


**FIGURE 2.9a** Buy high and sell higher

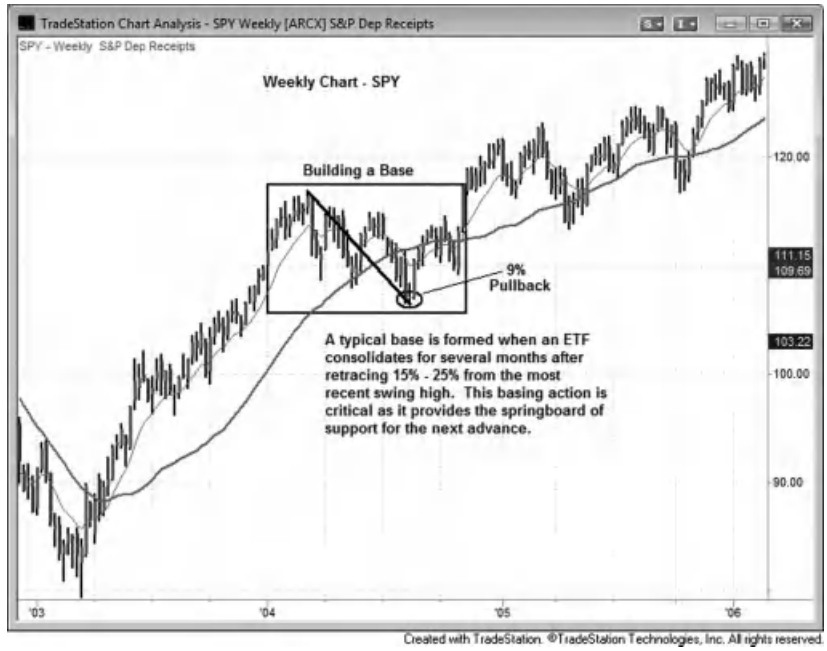
A "base" (basing formation) is formed when an ETF has consolidated in a fairly tight sideways range lasting several months to a year. A quality basing pattern, on average, involves a correction of 10–30 percent off the most recent "swing high" (the highest preceding level an ETF has reached within the current trend). A base is crucial to an uptrend, as the ETF builds a strong foundation to launch the next advance.

Before an ETF can break out to new highs, it must have a solid basing pattern to build upon. It's sort of like the foundation for a house; if it's not solid, the levels above can become unstable. For ETFs, base patterns serve as that foundation. They occur when an ETF's price retraces from its recent high and consolidates over a series of weeks or months. When technical conditions such as this present themselves, it may cause the ETF to meet our criteria for a potential buy entry. This is a setup.

Bases typically form after an ETF has already experienced a nice increase in its share price (also known as an uptrend) of at least 30 percent. That uptrend is important because it shows the ETF has built up a record of price growth already and has gained support from big professional investors. There are several kinds of bases that winning ETFs frequently form prior to a big price run-up. Figure 2.10 demonstrates the most common type of base.

In Figure 2.10, the annotation says we typically look for a "15 to 25 percent" pullback from the high, while the base is being formed. However, this depends greatly on the volatility and type of ETF. In the case of S&P SPDR (SPY), for

**FIGURE 2.10** Proper basing pattern



example, an 8 to 10 percent pullback is already substantial enough because it is an ETF that tracks a broad-based index. However, in the case of an ETF such as ProShares Ultra S&P 500 (SSO), which is designed to track at approximately 200 percent the movement of the underlying S&P 500 Index, that same pullback would be 16 to 20 percent. The more important factor is that the pullback is orderly, holds in a sideways range, and then starts developing a tightening basing pattern.

Figure 2.11 shows an ideal two-month basing pattern from which a buy setup is formed. Notice that once the horizontal resistance line is penetrated, an explosive move ensues. Nevertheless, the ETF once again pulls back to test its breakout shortly after the first breakout higher. This is common and not a problem because our initial protective stop is set just below the low of the basing formation (around $14.10 in Figure 2.11). Using a disciplined "set it and forget it" mentality with regard to stops eliminates emotions from the trade and enables you to sit through the pullback. Furthermore, when an ETF pulls back immediately after its first breakout attempt, it has the effect of causing nervous buyers ("weak hands") to sell quickly, at the first hint of trouble. This has the positive effect of absorbing overhead supply, which enables the ETF to subsequently move higher more easily. In fact, some of the most explosive upward moves we have seen were first subject to a bit of "shakeout" action after the initial breakout.

If a breakout buy entry is missed, there's no reason to chase the move. We simply wait for the first pullback to a support level, wait for a new setup to develop, and

**FIGURE 2.11** Breakout from buy setup after base

**FIGURE 2.12** Pullback buy entry


enter the trade based on the secondary entry point. In a strongly trending ETF, we usually look for an "undercut" (one or two-day probe) beneath support of the 20-day moving average that quickly snaps back above it. Drawing simple trend lines to connect each "higher low" is another simple way to predict the depth of a pullback from an ETF that has broken out. The pullback entry is shown in Figure 2.12.

### 3. Have a Clearly Defined Exit Strategy

The goal of an exit strategy is to sell winning trades into strength during a rally. By having a predefined price target, a position is sold into strength to maximize profits. Typically, trades sold into strength receive better execution (less slippage). Figure 2.12a is a clear example of how we seek to focus on selling into strength after each breakout makes a substantial move higher.

However, when a trade doesn't go as expected, we always honor our preset stop price (typically around 7 to 8 percent below the entry price, but based on horizontal price support levels). Not all trades are winners, and that is why we have a set of rules for exiting a trade. It's all about risk control. The protective stop is the "line in the sand," the point at which it no longer makes sense to be in the trade. It's the point past which it is too risky to remain in the trade. The charts shown in Figures 2.13 to 2.15 clarify the importance of a sound exit strategy.

As you can see, failure to honor your predefined stop price in this example of UNG would have resulted in a very painful loss that could be quite difficult for your trading

**FIGURE 2.12a** Selling into strength


**FIGURE 2.13** Importance of clearly defined exit strategy (example 1)

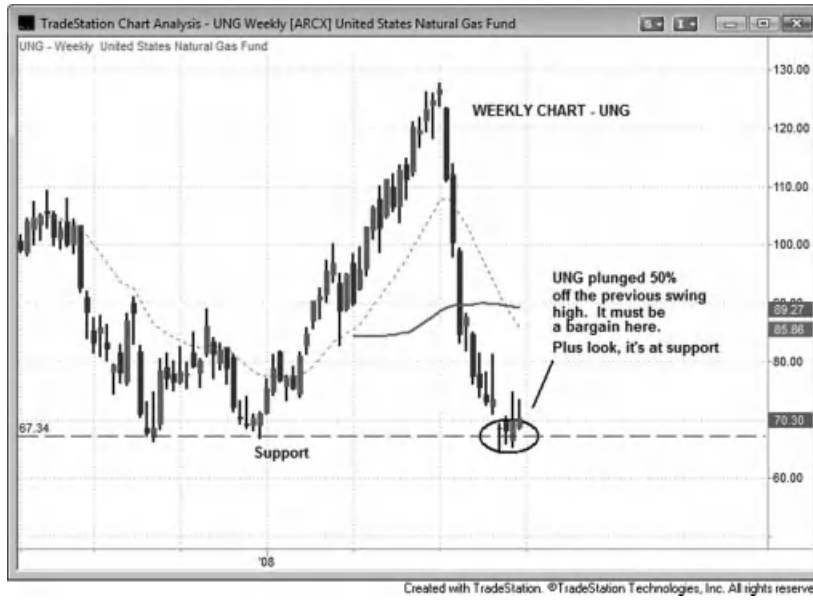


**FIGURE 2.14** Importance of clearly defined exit strategy (example 2)

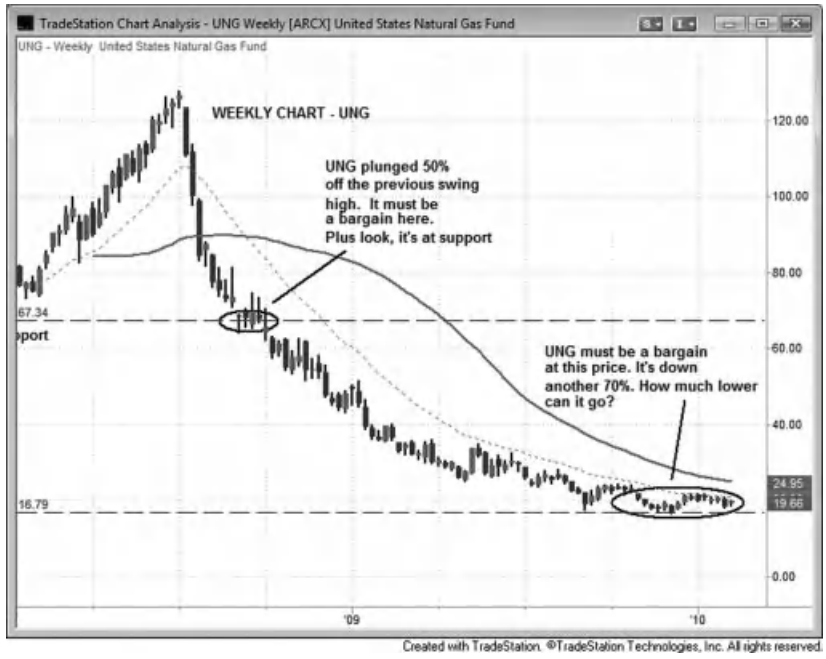



**FIGURE 2.15** Importance of clearly defined exit strategy (example 3)

account to recover from, especially if the initial placement of capital into this one trade was too large for solid risk management, which is the focus of the next point.

### 4. Have a Disciplined Money Management Strategy

Below are our five key money management rules. Commit them to memory and follow them at all times:

1. Never risk more than 2 percent of total account value on any individual trade (no matter how great the setup looks).
2. Average risk per trade *when conditions are optimal* is 1−2 percent. This should prevent the experienced trader from ever losing more than 15−20 percent of his or her account value in an unexpected market move.
3. New traders should risk a maximum of 0.5 percent per trade to prevent massive drawdowns when first learning to trade.
4. Do not take capital exposure of more than 10 percent of account per trade.
5. Risk control should always be a trader's foremost concern. You have to live to fight another day. If you blow up your account, you're out of the game.

Table 2.1 shows why risk control (quickly cutting losses each and every time a stop triggers) is so important. The further an ETF declines from the purchase price, the more difficult it is to earn the losses back (get back to breakeven). At a 5−10 percent account drawdown, the gain needed to reclaim the break-even level is very manageable. However, at losses of 20 percent and beyond, the recovery percentage

**TABLE 2.1** Why Risk Control Is Everything

| Amount Stock Drops | Gain Needed to Break Even |
|---|---|
| 5% | 5.26% |
| 10% | 11.10% |
| 20% | 25.00% |
| 30% | 42.86% |
| 40% | 66.67% |
| 50% | 100% |
| 60% | 150% |
| 70% | 233.33% |
| 80% | 400% |
| 90% | 900% |

*Source:* Morpheus Trading Group

**FIGURE 2.16** Properly using protective stops (example 1)


makes it very difficult to overcome the drawdown. *A 50 percent loss requires a 100 percent run-up just to get back to breakeven*.

To prevent having a small, manageable loss turn into a devastating loss, such as shown in Figures 2.13 to 2.15, it's critical to have clearly defined protective stop prices before entering every trade. This enables the average losing trades to be much smaller than the average winning trades. Figures 2.16 and 2.17 illustrate a controlled and disciplined way for exiting losing trades.

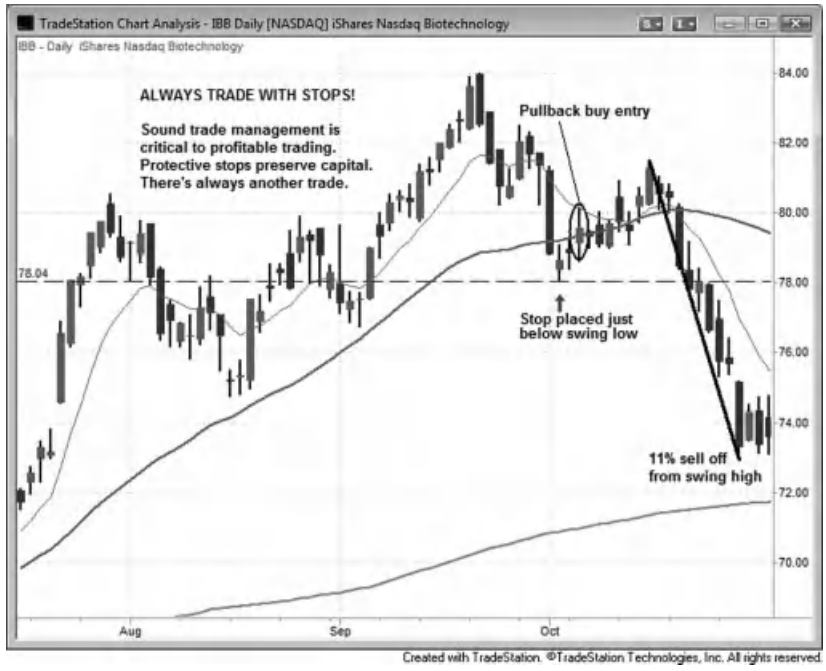
## 5. Understand the Psychology of Trading

The price movements in all markets are driven by four primary emotions that can create an emotional roller coaster if not controlled: greed, fear, hope, and regret. Combined, they probably account for more lost money than anything else in trading. Without an understanding and command of these powerful emotions and how they relate to trading, it is virtually impossible to become a master trader:

**Greed** is a powerful emotion, as it can drive ETF and stock prices well beyond "reasonable" valuations. Greed creates a state of euphoria within individuals and in the market (group), which has a blinding effect on rational thought.

**Fear** is also a powerful emotion, much more so than greed. It's probably the most powerful of all human emotions. As an example, markets tend to rally at a methodical pace over periods ranging from several months to several years to

**FIGURE 2.17** Property using protective stops (example 2)




several decades. However, during a market correction (panic), years of gains can be erased in just a few months. The fear of losing money creates panic and sends the market sliding out of control at a pace unimaginable to most.

**Hope** may be the most dangerous of the three emotions, as it serves to paralyze market participants. As individuals, when a trade is moving against us, it is common to analyze and rationalize all the reasons that a stock should not be falling in value. Human nature is such that we don't like to admit to being wrong and don't like to take losses. Further, as traders, we have a tendency to underestimate the potential severity of declines and advances in the market. As a consequence, we frequently become paralyzed and avoid taking action to eliminate a losing trade. This has been the death knell to many individuals who started out trading and refused to let go of their ego.

**Regret** and hope should likely share an equal weight in any discussion on trading psychology. Regret is a dangerous emotion because it often leads to a depressed emotional state, self-loathing, and revenge trading. Missing trade entries and poor exit management are generally the root cause of regret.

Much more detail is provided in our chapters on the psychology of trading. But for the moment, suffice it to say that most traders fail miserably when it comes to understanding trading psychology and its importance in their growth and success as traders.

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PART II

# Advanced Technical Analysis Strategies for Trading ETFs

# CHAPTER 3

# Candlestick Patterns

Candlestick patterns provide not only important information on the price movements of ETFs, but also key insight into the psychology of the market. In this chapter, we will elaborate on this concept.

## What Is a Candlestick?

A candlestick is a charting technique that visually represents the opening, high, low, and closing prices of a security. The pattern resembles a candlestick and hence its name. These patterns are plotted on a chart each day (or other time interval) to reveal trends and possible price reversals in a security. Common candlestick patterns include doji stars, shooting stars, hanging man, and engulfing formations, to name a few. Both individual and clusters of candlesticks are used by market technicians to gain insight into potential future price action in a security. These include both bullish and bearish continuation, hesitation and reversal candles, and bullish and bearish patterns that are formed by combining multiple individual candlesticks.

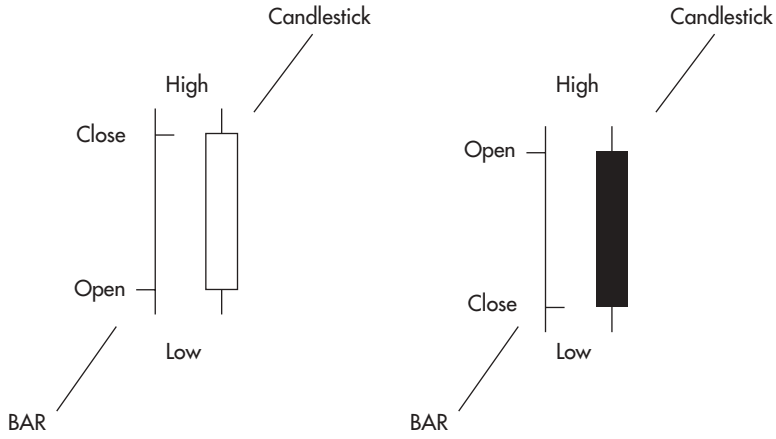
## History of Candlestick Charting

The concept of the candlestick pattern was invented in 17th-century Japan as a simple way to track the price of rice. However, in the mid-18th century, a famous Japanese merchant named Hakata, through his extensive research on the seasonal movements of rice prices, began using candlesticks to predict the future price movements in rice. This information subsequently enabled him to become a very successful trader in the commodity. Although he did not invent candlestick patterns, Hakata is widely viewed as the grandfather of candlestick charting.

About 150 years later, candlesticks were widely introduced to modern technical traders, thanks to the work of Steve Nison. His 1989 book, *Japanese Candlestick Charting Techniques*, is considered by many to be the bible of candlestick charting.

It is widely held that prior to candlestick analysis, the bar chart was the most commonly used pattern to analyze price action in the market. Both candlestick and

**FIGURE 3.1** Side-by-side comparison of candlestick to bar formations




bar charts provide the same information with respect to price action (see Figure 3.1). Both charting techniques reveal the opening, high, low, and closing price of a particular index, ETF, or stock on a particular day. However, the most likely reason that candlesticks have become a more popular trading tool is that *they use colors to reveal the critical and insightful relationship between opening and closing prices*. Typically, candlestick chartists use green or white candles to represent a higher closing price and red or black candles to represent a lower closing price.

In order to better understand how to use candlestick patterns as part of your technical trading, let's first define how to "read" a candlestick and use this information to look at an overview of the patterns that we have found to be the most reliable in our trading.

In charting software, a candle is white (or green) if the price at the close of the trading day is higher than the price at the open. A candle appears as black (or red) if the closing price is lower than the price at the open. The narrow line (generally referred to as a tail, stick, wick, or shadow) on a candlestick shows the entire range of prices traded during the period (high to low), while the wide mid-section or "body" reveals the opening and closing prices for the period. Figure 3.2 illustrates these parts of a candlestick.

Some candlesticks will not have a tail or wick. This only occurs if all of the day's price action is included in the body of the candle. In other words, no wick forms because the opening and closing prices mark the high and low of the day. This type of candlestick pattern is referred to as a Marubozu formation (see Figure 3.3). Throughout this book, candlesticks with higher closing prices will be represented by lighter colored or white candles and candlesticks with lower closing prices by darker colored or black candles.

Notice that Marubozu candlesticks contain no wicks. As stated earlier, all price action is contained within the body of the candle.

**FIGURE 3.2** Price action revealed by candlesticks

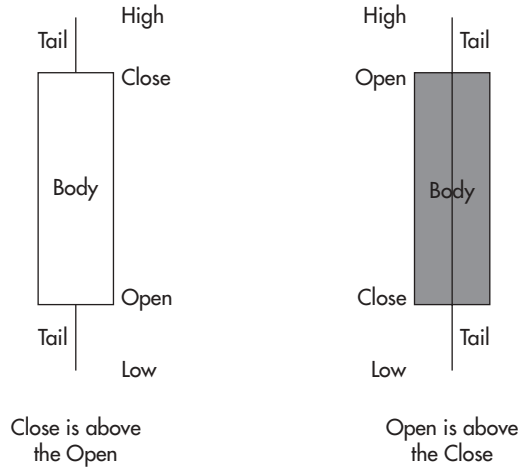
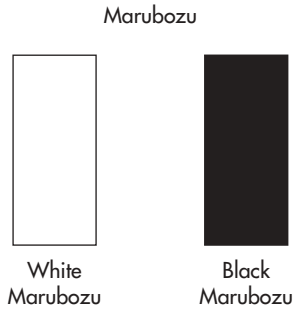



**FIGURE 3.3** Marubozu candlesticks




Because there are dozens of candlestick patterns, it is beyond the scope of this book to address each of them. However, we will focus on those candlestick patterns that we have found most useful from our own trading experience and back-testing.

It is important to note that we do *not* trade solely off candlestick patterns. Rather, we rely on these patterns as signals for potential trade setups, for setting stops, as signals for trend continuation, and warning signs for potential trend reversal. Price action ultimately determines whether or not we enter or exit a trade, not the candlestick pattern.

In our own trading, we have found the following three candlestick patterns to provide the most reliable signals: engulfing, shooting stars, and hammers.

## Engulfing—Both Bullish and Bearish

Engulfing candles can be either bearish or bullish and tend to be very reliable indicators of trend reversal. Bearish engulfing candles occur when the next day's price action completely blankets (engulfs) the previous day's price action, and the close is

lower than the open. Bullish engulfing candles occur when the next day's price action completely blankets (engulfs) the previous day's price action, and the close is higher than the open (see Figure 3.4).

The market psychology behind engulfing candles is simple. In the case of a bearish engulfing candle, they typically signal a potential market reversal near resistance or at exhaustion during an uptrend. They form when an uptrend is in place and a smaller white candle is engulfed by a much longer black candle, which suggests that market bulls are losing control. This is particularly true when the bearish black candle forms on higher volume than the white candle it engulfs. Further, the larger the black candle is compared to the white candle, the more powerful the signal. It is important to note that the previous day's candle (the one being engulfed) does not necessarily have to be white. It is acceptable if it is a small black candle (close is lower than the open). Figure 3.5 is a daily chart of the S&P 500 SPDR ETF (ticker symbol: SPY) that depicts an actual bearish engulfing candle.

**FIGURE 3.4** Bearish and bullish engulfing candles (signal potential trend reversal)

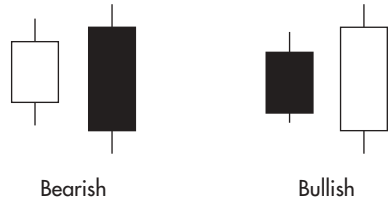



**FIGURE 3.5** Bearish engulfing candle on SPY

**FIGURE 3.6** Bullish engulfing candle on QQQ

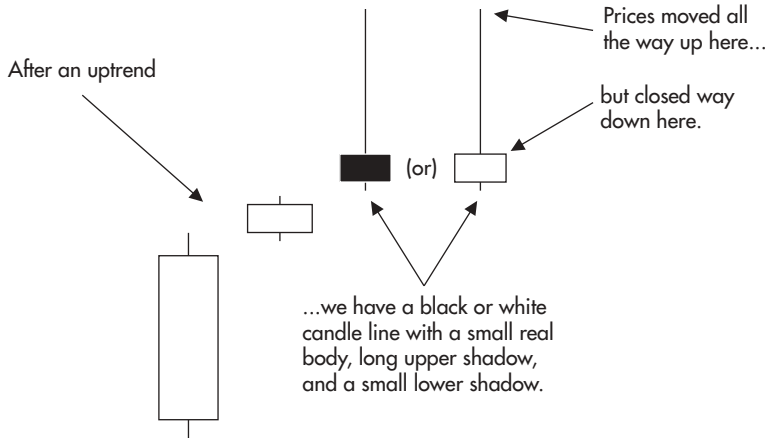

Notice that SPY had been in an uptrend, and the price action began to stall on November 7–8, 2010. On November 8, a smaller candle was formed that was totally engulfed by the significantly larger bearish candle formed on November 9, 2011. The opening price of the November 9 candle almost marked the high of the day, and SPY closed near the lows of the day. Five days later, SPY had declined nearly 4 points.

Now let's turn our attention to a bullish engulfing candle formed by the PowerShares QQQ Trust, a popular ETF that tracks the performance of the Nasdaq 100 Index (ticker symbol: QQQ) in May 2009, which signaled a potential upside reversal. In Figure 3.6, notice that QQQ was in a pullback and appeared to be trying to find support just below its 20-day exponential moving average (20-day EMA) on May 21 and 22. Then, on May 26, 2009, QQQ formed a massive engulfing candle on a surge in volume. Within 10 subsequent days, QQQ had rallied more than 3.5 points (more than a 10 percent gain). In our *Wagner Daily* swing trading newsletter, we actually entered this position on May 26, 2009, just above the previous day's high. Our entry price was $34.05, and we exited five days later at $36.70, yielding a gain of 2.65 points.

## Shooting Star—Bearish Reversal Pattern

The next candlestick pattern is one of our favorite patterns. It occurs near the top of an uptrend or protracted rally and is known as a "shooting star" candlestick pattern. This pattern is shown in Figure 3.7.

**FIGURE 3.7** Bearish shooting star reversal candle




As Figure 3.7 illustrates, shooting stars occur near the end of an uptrend and are characterized by a long wick that marks the high of the day and a short candle body that forms near the low of the day. Shooting stars are considered bearish reversal patterns. They represent a battle between market bulls and bears in which early day price action is dictated by bulls, but late day action is controlled by market bears. The price action is such that a very long wick forms. The longer the wick, the more likely the ETF will subsequently move lower.

Psychologically, think of the panic that bulls would be feeling as they watch a massive intraday move higher deteriorate and put their open position under pressure. Regret also creeps into the picture, as more and more bulls wish that they had sold before the breakdown. If the market opens lower the next day, panic will often ensue, resulting in heavy selling. Shooting star reversal candles generally provide the best signals when the market is undergoing a countertrend bounce within a dominant market downtrend, or when the market is reaching a former resistance level or swing high after an extended uptrend (given that we are trend traders, we generally won't initiate short entries during a bull market). Let's look at a few examples of shooting star reversal patterns, beginning with Figure 3.8.

On March 24, 2008, at the start of the banking crisis, a massive shooting star reversal candle appeared on a chart of the SPDR S&P Regional Bank ETF (KRE). We took a short position in KRE on March 25, when it dropped below the lows of the shooting star candlestick. Note that we did not enter the trade only because a shooting star formed; rather, we did not enter the trade until we also had price confirmation to enter the trade on March 25. A reversal candle is only a warning sign and not a trigger. The trigger for short selling occurred when KRE lost support at the March 24 low, at which time we set our stop just above the high of the reversal candle (which acts as near-term resistance).

Even though KRE reversed and closed in the middle of its March 24 trading range, we did not panic and exit the trade. We remained in the trade until April 16, 2008, when KRE gapped higher. On gap-ups, our rule is to not cover the trade until the ETF trades above its five-minute high. We don't exit the trade until a move

**FIGURE 3.8** Shooting star candlestick pattern in KRE


occurs above the five-minute high because the gap is counter to the prevailing trend and countertrend gap-ups often fail.

The reason that shooting star reversal candles are a reliable trading tool is that the high of the candle is rarely violated during a downtrend because it marks a point of extreme investor sentiment, when sellers step in and overwhelm buyers. During strong broad market uptrends, the failure rate on this pattern is higher since price action often merely just stalls following a shooting star reversal candle, or the market pulls back only modestly and then consolidates before heading higher. Further, in firmly established uptrends, there are frequently no major resistance levels, as ETFs and the market are breaking out to new highs and are well above all moving averages. But when price action "overcuts" (briefly probes above) an important resistance level, it is much more likely that a shooting star pattern will follow through and lead to a downside reversal. Still, extreme moves higher that approach Fibonacci extensions (explained in Chapter 4) and create severe overbought readings with RSI and divergences with accumulation-distribution (A-D, covered in Chapter 5) are also reliable signals.

## Hammer—Bullish Reversal Pattern

The final candlestick pattern we use extensively in our ETF trading is the bullish "hammer" candlestick pattern. This candle formation is particularly useful for identifying potential upside trend reversals after severe selloffs, or pullbacks into

support within an uptrend. Basically, the bullish hammer is simply the inverse pattern of a shooting star.

Figure 3.9 provides an ideal representation of a bullish hammer reversal candlestick.

A hammer is a bottoming signal. It has a long lower shadow and a small body (either black or white). The market or ETF should be in a downtrend when this

**FIGURE 3.9** Bullish hammer reversal candlestick pattern

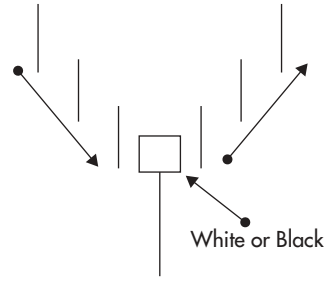



**FIGURE 3.10** PPH bullish hammer candlestick pattern

pattern forms. Hammer patterns are the most powerful when the shadow (wick) is extremely long and "undercuts" (briefly dips below) a key support level, or when it forms at the end of a high-volume capitulation move. Ideally, the shadow (wick) should be at least twice as long as the body of the candle.

Let's look at an actual chart of a bullish hammer in action, as shown in Figure 3.10. From August 27, 2010, until late October 2010, the Market Vectors Pharmaceutical ETF (PPH) was in a solid uptrend. Shortly thereafter, this ETF reversed trend, pulled back, and undercut its 200-day simple moving average (200-day MA). On November 29, 2011, as PPH undercut its 200-day MA, it also formed a massive bullish hammer reversal candle. This provided us with a clue that the pullback might soon reverse. Our buy entry was triggered by the gap-up that occurred on December 1, 2010. We entered the trade above the five-minute high. Notice the spike in volume that occurred on the day the reversal candle was formed. In December, we sold our position when PPH traded below the shooting star reversal candle that formed on December 15, 2010.

Candlestick patterns are a very important part of our technical trading methodology, and they are used on a daily basis when analyzing every trade or potential trade. However, we want to reinforce that trading decisions for entry or exit should NOT be based solely on candlestick patterns. Rather, think of these patterns as providing an early warning signal or "yellow flag" that alerts you to watch for subsequent price confirmation. When used in combination with moving averages, support and resistance lines, and volume, candlestick patterns can significantly enhance your trading.

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# CHAPTER 4

# Fibonacci Here, There, and Everywhere!

## What Is Fibonacci?

Fibonacci retracements, extensions, and time series are technical trading tools that derive their importance from a mathematical sequence known as the Fibonacci summation series. This mathematical sequence was first recognized by the 13th-century mathematician Leonardo Fibonacci da Pisa.

Fibonacci is credited with, among many things, bringing the Western world the Arabic decimal system, an explanation of the mathematics contained within the Great Pyramids of Giza, and the Fibonacci summation series. Of course, we are most interested in the Fibonacci summation series and its importance as a technical analytic tool in predicting price movements and support and resistance levels in the markets.

Fibonacci was born in Pisa, Italy about 1170 A.D., the son of a wealthy merchant. As a young man, Fibonacci traveled with his father to what is now Algeria in North Africa, where he was educated by the Moors in the "Hindu-Arabic" decimal-based numeric system.

## Order out of Chaos: The Fibonacci Summation Series

Fibonacci is well known for using mental puzzles to solve mathematical problems and derive many of his mathematical theories. Fibonacci posed the following mental puzzle in his treatise *Liber Abaci*, published in 1202 A.D., from which he derived his famous summation series: "How many pairs of rabbits will be produced in a year, beginning with a single pair, if in every month each pair bears a new pair which becomes productive from the second month on?"

This puzzle led to the amazing Fibonacci summation series, which is derived by first taking any two numbers and adding them together to get a third number. Then,

the third (next) number in the sequence is added to the number before it to get the fourth (next) number in the sequence, and so on.

The formula is more easily illustrated as follows: $0 + 1 = 1$, $1 + 1 = 2$, $2 + 1 = 3$, $3 + 2 = 5$, $5 + 3 = 8$, $8 + 5 = 13$, and so on. Therefore, the outcome of the basic sequence would look like this: 0, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233, and so on.

To mathematicians, this additive series is based on the equation: *phi* + 1 = *phi* squared. What is absolutely fascinating about this sequence is that if you take *any* number in the sequence and divide it by the very next number after it in the sequence (after the first 8 additions or sequences), you *always* get a ratio approximating 0.618. Along the way to approaching the ratio 0.618, you will get a sequence of numbers that oscillate or iterate around 0.618 (the first ratio in the sequence just a bit lower than 0.618 and the next ratio in the sequence just a bit higher than 0.618). *This oscillation around 0.618 is mathematically important in understanding the wavelike movements found in the expansions and contractions in the markets*. Further, if you take any number in the sequence (after the eighth sequence) and divide it by the number before it in the sequence, the resulting ratio approximates 1.618. The number 1.618 is known in geometry as the golden ratio, the golden mean, or the divine proportion and is denoted by the Greek letter *phi* (Φ).

*Phi* (Φ) is an irrational number. There is no equivalent fraction for Φ and its decimal representation continues to infinity. A quick review of the following number sequence clearly demonstrates how the Fibonacci summation series iterates around the golden ratio of 1.618:

1/1 = 1
2/1 = 2
3/2 = 1.5
5/3 = 1.666 . . .
8/5 = 1.6
13/8 = 1.625
21/13 = 1.61538 . . .
34/21 = 1.61905 . . . slightly above 1.618 (8th number in sequence)
55/34 = 1.61764 . . . slightly below 1.618
89/55 = 1.61861 . . . slightly above 1.618

Notice that once you get to the eighth number in the series (8 is also a Fibonacci number), each number thereafter begins the iteration above and below the golden ratio (1.618).

What is also interesting about this number sequence is that you can take any two numbers as the starting point in the series, run the calculations for at least eight sequences (8 is a Fibonacci number), and you are able to calculate the golden ratio as demonstrated above. In other words, as you calculate eight or more sums in the sequence, you begin to approach the golden ratio or *phi*.

For example, if we randomly select two numbers, such as 187 and 447, and add these numbers together, the result is 634. Now, if we add 634 to 447, we get 1,081. Next, suppose we were to calculate the series out a total of 12 sequences (randomly chosen because it's greater than eight). We would get the following result: 1,081 + 634 = 1,715, 1,715 + 1,081 = 2,796, 2,796 + 1,715 = 4,511, 4,511 + 2,796 = 7,307, 7,307 + 4,511 = 11,818, 11,818 + 7,207 = 19,025, 19,025 + 11,818 = 30,843, 30,843 + 19,025 = 49,868 49,868 + 30,843 = 80,711, and 80,711 + 49,868 = 130,579 (12th number in sequence). Now if we divide the last number in the sequence by the previous number in the sequence, we get 130,579/80,711 = 1.6179. As expected, this result approximates *phi* or the divine proportion.

Suffice it to say that the golden ratio is an important number in geometry, and from it the golden rectangle and the golden spiral can be derived. *Both are related to the geometric wavelike characteristics of the price action in stock charts, as we will soon show you*.

The golden rectangle is a rectangle such that the proportion of the long side of the rectangle compared to the short side of the rectangle equals 1.618. Let's use an example to demonstrate this concept. In the rectangle in Figure 4.1, if line DC were 16 inches, then in order for the rectangle to be a golden rectangle, line AD would have to be 25.888 inches. This is determined as follows: Some number AD divided by line segment DC = 1.618. Therefore, AD/DC = 1.618. If DC = 16, then AD/16 = 1.618. If we multiply both sides of the equation by 16, we get (AD/16) × 16 = 1.618 × 16. Solving further, we get AD = 1.618 × 16, which simplifies to AD = 25.888 inches. Thus, side AD is equal to 25.888 inches. We now have a golden rectangle, as shown in Figure 4.1.

If we divide the golden rectangle (ABCD) by drawing a perpendicular line (EF), such that AE equals .618 of ED, the result is *another* golden rectangle (CDEF). Notice that when line EF is drawn, the result is a square (ABFE) and another smaller golden rectangle (CDEF). This process of dividing each subsequent golden rectangle into two parts (a square and the remaining part) results in a sequence of smaller and smaller golden rectangles. This is one of the most fascinating properties of the golden rectangle.

**FIGURE 4.1** Golden rectangle

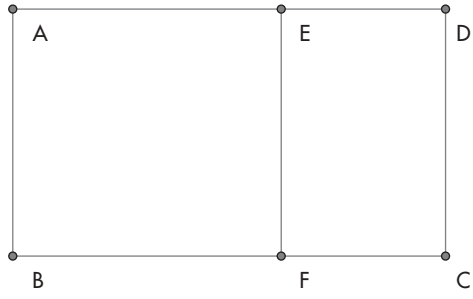
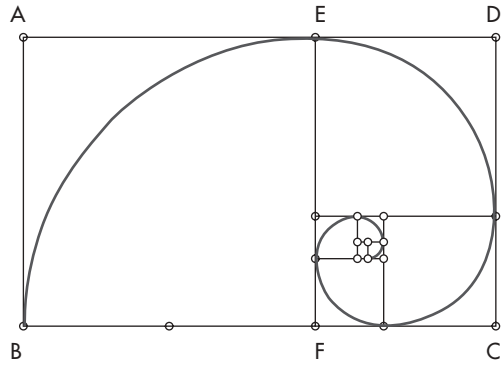


**FIGURE 4.2** Golden spiral




In Figure 4.2, each subsequent rectangle is precisely proportional to the original larger rectangle after a square is created within the golden rectangle. Both ABCD and CDEF are golden rectangles. This relationship carries on into infinity and creates what is known as the golden spiral.

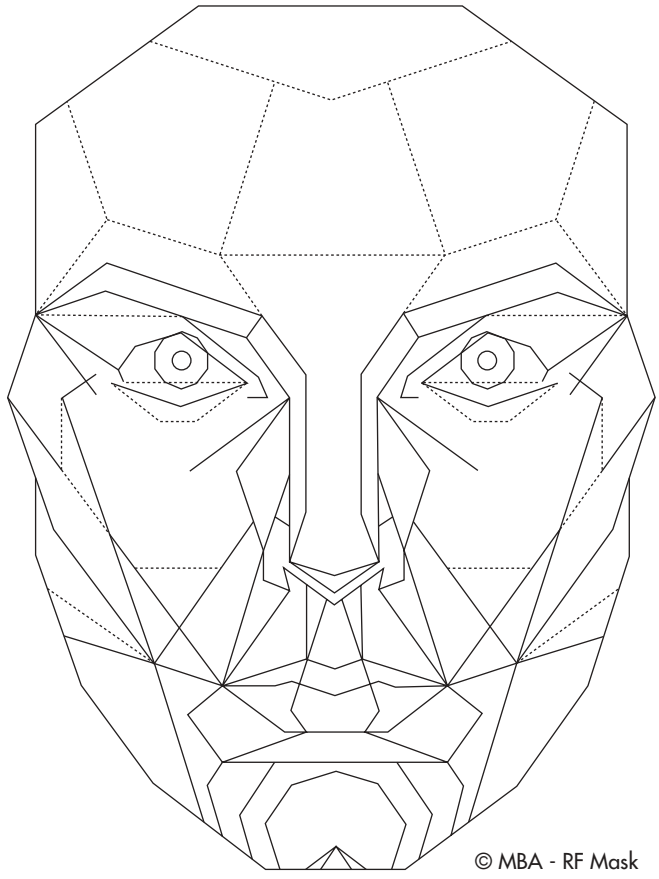
As you can see in Figure 4.2 if the Golden Rectangle is divided into a sequence of smaller and smaller squares, and if an arc is drawn such that it passes through abutting corners of each successively smaller square, the result is a line that forms a logarithmic or "golden spiral." This golden spiral is derived by drawing an arc that passes through each point and intersects the adjacent side. The drawing of the spiral just gives the appearance of being tangent to each point.

## Fibonacci Is Everywhere!

Since you probably never gave it any thought, you may be surprised to know that Fibonacci numbers and ratios occur extensively throughout nature. The human body has two arms, two legs, and one head, which totals 5, a Fibonacci number. Humans also have five senses. The ear is a perfect Fibonacci (golden) spiral. The eyes are located exactly 50 percent from the top of the head while the nose is approximately 61.8 percent from the top of the head (both Fibonacci ratios). Plastic surgeons utilize Fibonacci masks to replicate beauty when performing surgery. Long before plastic surgery, artists already knew that beauty is perceived in terms of Fibonacci ratios, and this knowledge has been used for centuries. Figure 4.3 is a typical Fibonacci mask used by plastic surgeons.

The golden ratio is also seen in the arrangement of the seeds in a sunflower and in the shape of pine cones. It is widely thought that these patterns occur in nature because one of the most efficient ways to get the most into the least space is through the mathematics underlying the Fibonacci summation series (golden spiral). Furthermore, the nautilus shell, galaxies, and even subatomic crystals have been found to

**FIGURE 4.3** Fibonacci mask used by plastic surgeons




*Source*: www.beautyanalysis.com/index2_mba.htm

be perfect Fibonacci spirals (golden spirals). On many types of plants and trees, the branches also grow in a spiral fashion around the stem or trunk. This phenomenon is known as spiral phyllotaxis. The important point is that the golden ratio and Fibonacci numbers exist everywhere in nature and the universe. Leonardo Fibonacci was indeed quite clever!

Now that we have established the importance of Fibonacci numbers in math, science, nature, art, beauty, and the universe, we will now turn our attention to the importance of how Fibonacci ratios interrelate with price action in the stock market.

## Fibonacci and the Markets

Before we begin exploring specific examples of how Fibonacci ratios are used in trading ETFs, let's first review some basic terminology related to Fibonacci analysis.

### Fibonacci Price Retracements

This refers to rallies off support levels during selloffs/downtrending markets *or* pullbacks from resistance levels during rallies/uptrending markets. The retracements are expressed as one of the key Fibonacci ratios, such as 0.236, 0.382, 0.50, 0.618, or 0.764. Simply put, *Fibonacci retracements are merely a predicted percentage pullback based on the Fibonacci ratios when an ETF is moving higher, or a percentage bounce based on the Fibonacci ratios when an ETF is moving lower*.

Fibonacci retracements are drawn in a charting software platform between significant previous swing highs and swing lows in the market, and they can be used over any time frame. When an ETF is moving lower or in a downtrend, the Fibonacci levels are drawn as percentage bounces off the swing low (using the Fibonacci percentages). In a move higher or an uptrend, the Fibonacci levels are drawn as percentage pullbacks from the swing lows.

### Fibonacci Price Extensions

This refers to advances beyond a previous swing high or swing low in an ETF, stock, or index. Price extensions are based on the same Fibonacci ratios as price retracements. However, whole numbers are added to the key Fibonacci ratios, since the price is extending beyond the prior swing high or swing low, which is considered the 100 percent mark. Therefore, price extensions are expressed as 1.236, 1.382, 1.50, 1.618, 1.786, 2.382, 2.50, 2.618, and so on. Think of it this way. An extension is beyond the prior swing high or low, and therefore it is greater than 100 percent of the prior swing high or swing low. Thus, 1.382 would be a move that is 38.2 percent beyond the swing high or swing low.

### Price Retracement and Extension Ratios (Percentages)

Throughout the book, we use either decimal fractions or whole number percentages interchangeably to identify Fibonacci levels. For instance, for Fibonacci retracements, we might use .382 or 38.2 percent. For Fibonacci extensions, we will use either 1.382 or 138.2 percent as representations of the same value. This holds true for all Fibonacci levels. For trading purposes, we generally rely on Fibonacci retracements of 0.236, 0.382, 0.50, 0.618, and 0.786, as well as Fibonacci price extensions of 1.236, 1.382, 1.618, and 2.618.

### Fibonacci Time Series (Time Extension Lines)

Fibonacci time extension lines are analytical drawing tools used to mark particular time periods that may act as a pivot point (turning point) in the current trend. Fibonacci time extensions could be thought of as "time resistance/support," the point at which the prevailing price thrust may be nearing exhaustion (up or down). When Fibonacci time series lines match up with Fibonacci retracement and extension levels,

we have found it increases the odds that a shift in price movement is likely. Further, when price retracements/extensions drawn over varying price levels (i.e., drawn from various swing highs to various swing lows in a downtrend, or vice versa in an uptrend) converge with Fibonacci time extensions drawn over varying time frames, we have found that the likelihood of a reversal in price is even more likely.

Support indicates a low or series of price troughs (pivots) where price action maintains (holds) this level. Resistance indicates a high or series of peaks where price action consistently stops moving higher. Obviously, identifying and monitoring support and resistance levels can assist in determining whether an ETF maintains the current price thrust or trend, or reverses its course. *Overall, Fibonacci numbers provide the ability to analyze potential price reversals by both time and price.*

Let's put it together with a chart of an actual ETF. Figure 4.4 is a daily chart of the Dow Jones Industrial Average SPDR ETF (DIA). This chart illustrates how accurate Fibonacci retracements (support and resistance levels) can be when applying them to predicted price movements. In this case, we are looking at a price retracement off the lows (bounce) within a downtrend.

**FIGURE 4.4** Fibonacci retracements within a downtrend on DIA

The numbers (1) and (2) represent where the Fibonacci lines were drawn, from the peak (swing high) to trough (swing low) of the downtrend. In an uptrend, the lines would be drawn from the trough to the peak. Charting software, such as TradeStation (tradestation.com), then automatically plots the Fibonacci retracement percentages after the range is selected and drawn.

The solid circles on the chart represent the 38.2 percent Fibonacci retracement level, the rectangles represent the 50.0 percent Fibonacci level, and the dashed circles represent the 76.4 percent Fibonacci retracement level. Notice how the rallies off the swing low (2) retraced and stopped several times at each of these levels.

Depending on the price volatility or beta (ß) and the severity of the prevailing trend in the ETF, we have found that different retracement levels present greater/lesser resistance. For instance, notice how DIA struggled to reclaim the 38.2 percent level. The difficulty that DIA faced at this level is likely attributable to the severity of the preceding downtrend. Fibonacci retracement levels are important because they act as support and/or resistance levels. Therefore, an ETF will often reverse and resume the direction of its prior trend when it encounters a Fibonacci level. In this case, DIA found resistance at the 38.2 percent, 50.0 percent, and 76.4 percent retracement levels. Notice that once an ETF breaks through resistance of a Fibonacci level, that level will often serve as support on the next pullback (or the support will act as resistance in an uptrending market).

If you bought DIA at point (2), you could have used the 0.382, 0.50, and 0.764 retracement levels as targets to take profits on your long position. In addition to using Fibonacci to determine price targets, you can also use retracement levels for setting stop losses. For instance, a move above the 0.382 retracement could have been used for exiting a short position in DIA.

Remember, the direction you draw the lines depends on whether the ETF/stock/index is in an uptrend or downtrend. After the lines are drawn, 0.382, 0.50, and 0.618 are your primary retracement levels. Secondary but still significant levels are at 0.236 and 0.764. *Bear in mind that the longer the time frame, the more accurate Fibonacci ratios tend to be*. In addition, you can also use multiple time frames to look for Fibonacci convergence, which is even more powerful, as it offers further confirmation.

## Tying It All Together

Based upon what we know about Fibonacci numbers, their presence in nature, and their proportional appeal to the human eye, it is believed that traders subconciously seek out the aesthetics and symmetry found in the day-to-day undulations of market price action. Fibonacci levels may also be related to the average individual's and ultimately the market's (group's) propensity to tolerate pain (fear/losses) and maintain optimism (greed/gains) before succumbing to a shift in trend. In fact, Fibonacci levels may be at the core of the greed, fear, hope, and regret that drives the psychology of trading. These psychological concepts will be explored in more detail in Chapter 8.

## Actual Trade Examples Using Fibonacci

Let's take everything we learned about Fibonacci and apply it to four real-life examples of how it can be used in trading. In this section, we will provide further insight on how we analyze charts using Fibonacci technical tools through *actual ETF trades* we made in our hedge fund.

### Example 1—EEB Short Entry

Figure 4.5 shows the Guggenheim BRIC ETF (EEB) during a major downtrend, from April 6, 2011, to October 4, 2011. At the time, EEB had just set a new 52-week low (excluding the "flash crash" of May 2010). Obviously, there was no way to know whether or not EEB had established a new, significant swing low; however, a big spike in volume occurred that day (October 4) and EEB formed a distinct reversal candlestick. These were the first two clues that EEB might have put in a near-term bottom.

In anticipation that a bottom might have been set, we used the Fibonacci tool in our charting software to draw price retracement levels for EEB. Because EEB was in a clear downtrend, the lines were drawn by dragging the tool from point A downward

**FIGURE 4.5** Drawing the Fibonacci lines for EEB

to point B on the chart. We then set price alerts at the 23.6 percent, 38.2 percent, and 50.0 percent Fibonacci levels, so that we were notified when EEB was coming into potential resistance. As a side note, we also set an alert if EEB broke below the October 4 low, as this would necessitate that we redraw the retracement lines. As it turned out, EEB did find a bottom on October 4 (see Figure 4.6).

The first indication that EEB might offer a shorting opportunity occurred on October 27, 2011, when this ETF formed a reversal candle on the highest volume since the October 4 reversal. However, there still was no setup (price confirmation) to justify entering a short position. But on October 31, 2011, EEB gave us a clean short entry as it gapped down and lost support of the two-day low. We set our stop just above the October 27 high ($40.84) and exited the trade on November 17, 2011, three weeks later, at a price of $37.60. This is shown in Figure 4.6.

Notice that we covered the short position at convergence of the 50-day MA and the 38.2 percent Fibonacci retracement level drawn from point B to point d. The EEB trade setup provided about a 2 to 1 reward-to-risk ratio (the potential profit was double the initial risk) and netted over a 5 percent gain. After we exited the position,

**FIGURE 4.6** Trade outcome of short position based on Fibonacci retracement

EEB eventually sold off and set another swing low at point d. This selloff to point d provided us with another potential short setup in EEB, as shown in Figure 4.7.

Looking at Figure 4.7, notice that EED set another pivot low at point d on November 25, 2011. This became evident when EEB gapped up the next business day (November 28). Once again, we used the Fibonacci tool to draw retracement lines, but this time we drew the lines from point c to point d.

It's noteworthy that the original Fibonacci retracement lines drawn from points A to B (Figure 4.5) also converged with the 61.8 percent retracement drawn from c to d (see the rectangle on the chart in Figure 4.7). Further, it was at this convergence level that EEB provided a short signal, as it formed a doji star on December 5, 2011. A short trigger occurred on December 8 when EEB gapped down and lost support of the three-day low.

Prior to December 8, no potential short setups had formed because EEB gapped up and rallied continuously until December 5, when deliberation occurred and formed a doji star candlestick pattern (an indication of indecision). We waited for this hesitation candle to form before we considered EEB as a possible short candidate.

**FIGURE 4.7** Fibonacci resistance levels provided secondary trade setup

We sold short EEB on the gap-down at $37.77 and set a stop above the December 5 high. We covered the short position on December 14, 2011, at the prior swing low of $35.11 for a 2.66 point gain.

## Example 2—QQQ

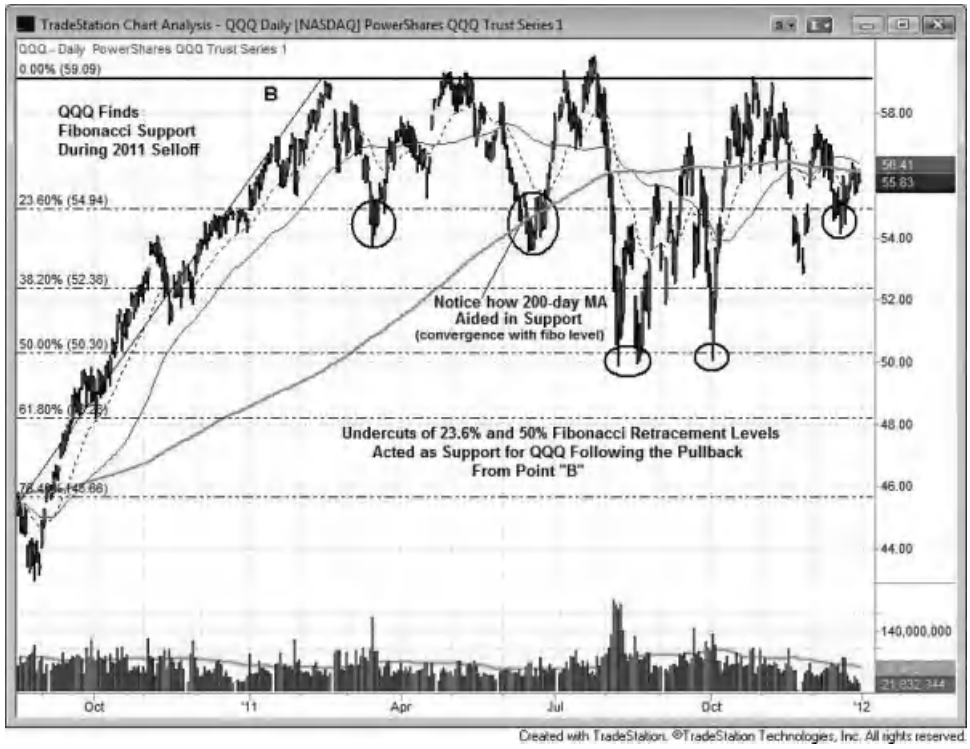
The next example of Fibonacci retracements was not an actual trade that we entered. Yet, it provides an excellent example of Fibonacci levels acting as support during an uptrend in the PowerShares Nasdaq Trust Series 1 (QQQ).

From July 1, 2010, QQQ was in a powerful uptrend that began showing signs of weakening at the swing high on February 16, 2011. Shortly after QQQ stalled out on February 16, we drew Fibonacci retracement lines from point A to point B, as shown in Figure 4.8.

The second chart of QQQ (Figure 4.9) is a close-up of Figure 4.8. The purpose for including this chart in our trade examples is that we also follow the action in the broad market to assist us in entering and exiting trades. Further, turning points in the major indexes are important since we often go to cash or lighten up on our long positions when the broad market shows stalling action or approaches resistance in an

**FIGURE 4.8** Fibonacci lines drawn on QQQ in an uptrend

**FIGURE 4.9** Close-up of Fibonacci levels at work with QQQ




uptrend, or when the market appears to be finding support while we're shorting in a downtrend. In Figure 4.9, notice how QQQ "undercut" and found support at the 23.6 percent and 50.0 percent Fibonacci retracement levels on numerous occasions.

## Example 3—XLP Long Entry

This trade example introduces the use of Fibonacci price extensions and price retracements used simultaneously. In late March and early April 2009, the S&P Select Consumer Staples SPDR Fund (XLP) had broken its downtrend, as it set a sequence of two higher-highs and higher-lows. However, on April 2 and April 3 of that year, XLP began showing signs of stalling when it struggled to rally above $22.00 and formed a long-legged doji star on April 3. Based on this stalling action, we drew both Fibonacci extension lines and retracement lines. Since XLP was in an uptrend, both sets of lines were drawn in the direction of the trend from point A to point B.

The retracement lines were drawn to provide potential support levels for a possible long entry should XLP sell off, and the extension lines were drawn to provide potential price targets in the event XLP continued its advance after consolidating or pulling back. This is shown in Figure 4.10.

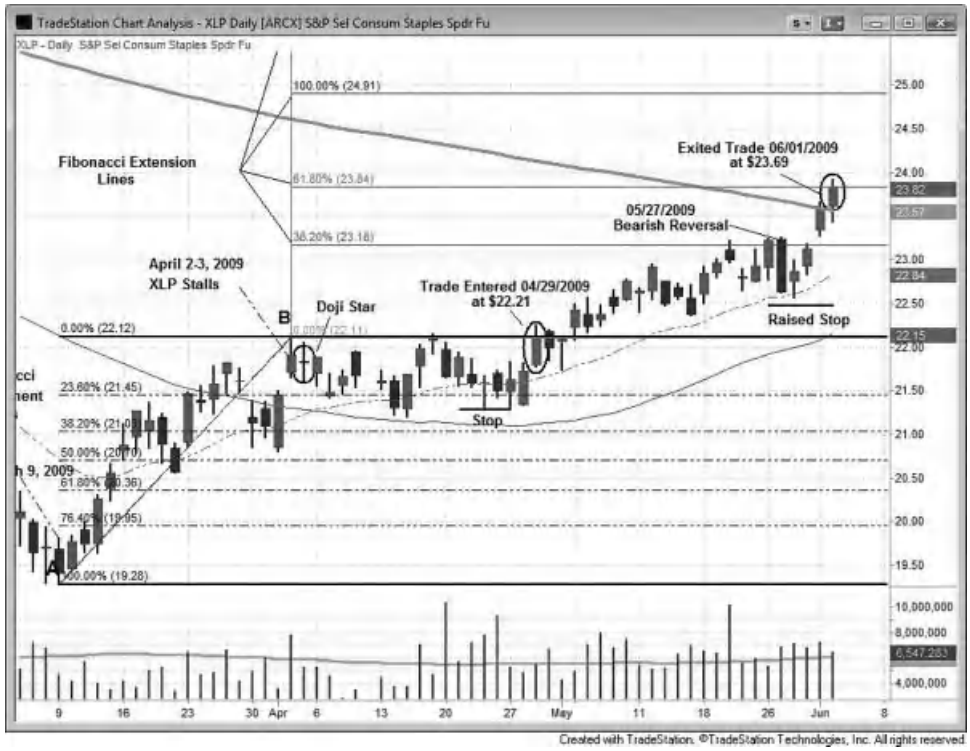
**FIGURE 4.10** Using Fibonacci retracement and extension lines simultaneously in XLP


The next chart of XLP (Figure 4.11) shows the results of the long entry into XLP. As it consolidated above its 50-day moving average, XLP showed considerable relative strength and only undercut the 23.6 percent Fibonacci retracement. Finally, on April 29, 2009, XLP provided a buy trigger as it rallied above resistance of the April 2 high ($22.13). We set our stop below the April 23 low of $21.30. We exited the trade on June 1, 2009, just below the 61.80 percent Fibonacci extension, yielding about a 6.0 percent gain. We almost sold the position on May 27, 2009, when XLP reversed sharply and closed near session lows. However, we decided to raise our stop to 10 cents below the 20-day EMA ($22.48) instead.

## Example 4—GLD Long Entry

This next trade setup was identified, entered, and exited using both Fibonacci time extension lines and Fibonacci price retracement levels. Fibonacci price retracement and time extension lines are used together in order to identify points of convergence

**FIGURE 4.11** Trade outcome for XLP long entry (using Fibonacci price extensions)




between the two, as a means to better time entries and exits from a trade. The following charts of GLD show an actual trade that we executed using Fibonacci price and time levels.

From January 27, 2011, until March 2, 2011, the SPDR Gold Trust (GLD) had made a powerful advance but appeared to be finding resistance near the March 2 high of $140.55. Prior to this, we had been tracking this move in GLD for a possible long entry. However, given its relative strength, GLD rallied so quickly that we were unable to identify an entry that provided a reasonable reward to risk ratio. We had to wait for a pullback.

When GLD began showing signs of stalling on March 2 and 3, we used the Fibonacci tools included with our trading platform to draw both Fibonacci price retracement lines (horizontal lines) and Fibonacci price extension lines (vertical lines). We drew both the price and time lines from point A to point B since GLD was in an uptrend (see Figure 4.12). However, when drawing Fibonacci time extension lines, we will often use multiple swing-highs and swing-lows over varying time frames. We draw time extension lines over various time periods in order to find potential zones of convergence among the various time frames. It is acceptable to draw Fibonacci time extension lines from swing-highs to swing-highs, swing-lows to swing-lows, swing-highs to swing-lows, and swing-lows to swing highs, irrespective of trend

**FIGURE 4.12** Using Fibonacci time extensions and price retracements together


direction. Make note of point Q in Figure 4.12, as it is an important point of reference with respect to Figures 4.13 and 4.14.

In Figure 4.13, notice that we drew another set of Fibonacci time extension lines from point Q to point B. We did this once GLD began selling off because we wanted to see if there were any time convergences during the pullback. When a time convergence occurs (two or more time extension lines overlap), the vertical time extension line becomes bold or the lines tightly cluster).

There were no time convergences on the pullback, but notice the convergence between the 38.2 percent Fibonacci price retracement line and the 38.2 percent Fibonacci time extension line (annotated by the squares in Figure 4.13). This convergence provided us with an important signal that the pullback was likely over. When price and time converge, there is a much greater likelihood that a reversal will occur. However, we didn't enter the trade when the convergence occurred; rather, we waited for price confirmation. As we've mentioned several times, we never trade off signals alone. We always wait for price to confirm the signal (look for a trade setup). In this case, GLD consolidated for three days just above the 38.2 percent Fibonacci

**FIGURE 4.13** Timing our buy entry with Fibonacci time extensions and price retracements


retracement. GLD found resistance at the three-day high from March 15 through March 17. But on March 18, GLD gapped above the three-day high, providing us with our buy trigger. This is all annotated in Figure 4.13.

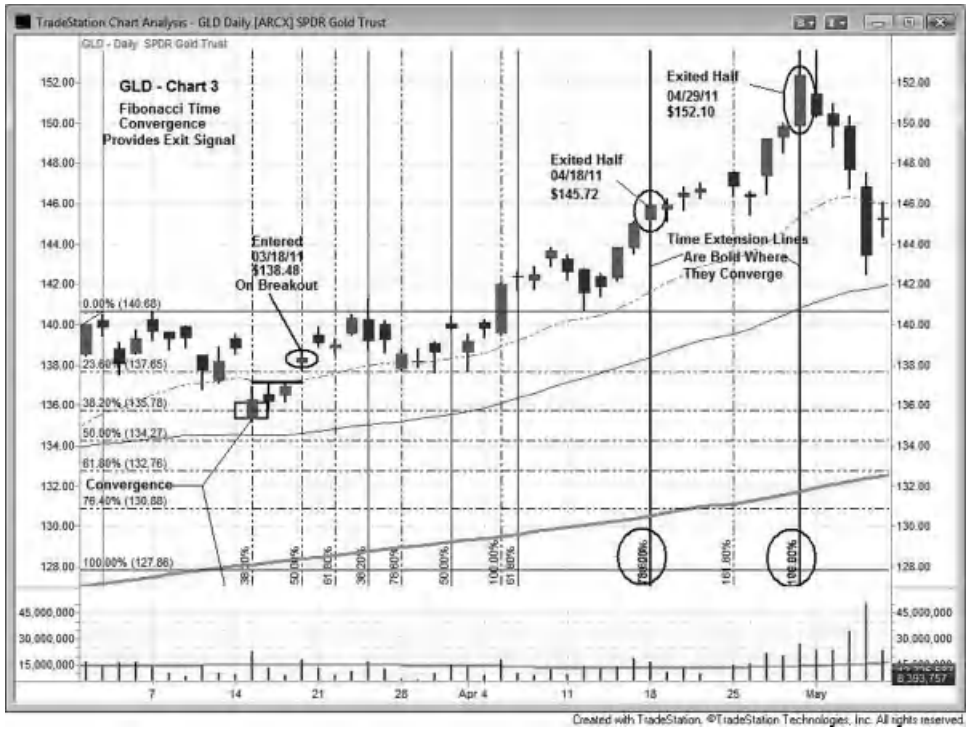
The third and final chart of GLD (Figure 4.14) demonstrates how we used Fibonacci time convergence to exit the position. As mentioned earlier, when vertical time lines converge, they will either cluster or overlap (bold vertical lines indicate overlap). On April 19, 2011, a time convergence occurred, so we exited half of the position.

We decided not to exit the entire position because GLD was in a strong trend, and it was not yet showing signs of distribution (heavy volume selling). Nevertheless, we raised our stop to just below the April 18, 2011, low, in the event GLD did reverse. On April 29, 2011, a second time convergence occurred and we exited the remainder of the trade. In situations where we maintain a half position in a trade, we generally exit the remaining portion of the trade if it hits our adjusted stop, the price action in the ETF reverses violently, or a second time convergence occurs.

GLD was a very successful trade. Thank you, Leonardo Fibonacci!

Although it may take a bit of time to fully grasp the concept of Fibonacci and its use in your trading, it's well worth the investment in time because Fibonacci price

**FIGURE 4.14** Exiting the trade based on Fibonacci time convergence




retracements, price extensions, and time extensions are extremely powerful trading tools. When used in combination, the signals they provide greatly increase the odds of a successful trade. Fibonacci price extensions can also be used in combination with price retracements and time extensions as another means to enhance your trading. There are many more examples we could provide with various combinations, but this gives you a solid framework to use Fibonacci moving forward.

*Advanced Technical Analysis of Etfs: Strategies and Market Psychology for Serious Traders*
by Deron Wagner, Edward Balog


# CHAPTER 5

# Accumulation-Distribution with RSI

Throughout this book, we will refer to the accumulation-distribution indicator simply as A-D. Further, accumulation-distribution will be represented by a line chart or a histogram. Following is a basic description of the accumulation-distribution indicator.

## Introduction to Accumulation-Distribution Indicator

The accumulation-distribution (by price and volume) indicator uses the relationship between the open and the close of the price bar, and the range of the bar, to determine whether the combination of price and volume should be characterized as accumulation (buying pressure) or distribution (selling pressure). The use of *both* price and volume provides an important insight with respect to the interaction of the two over an extended period of time. The interchange between price and volume reveals a different perspective as opposed to analyzing each independently.

The calculation of accumulation-distribution is a running total. Therefore, the trend direction (relative value) of A-D is more important than its numeric value (absolute value). A divergence between price and accumulation-distribution is used as a *leading indicator* that a trend reversal may be nearing. Other indicators, such as moving averages, are *lagging indicators*. Still, A-D should by no means be used as a trade entry or timing mechanism.

Since this indicator is considered a leading indicator, it is intended to provide a *signal* that a trend reversal may be underway *well in advance of the actual reversal*. This often results in false signals when using this indicator. Therefore, as with most technical indicators, it is *not* recommended to use A-D in isolation, or as a timing mechanism for specific trade entry. It is best used as an early warning signal that a trend could be weakening and a reversal might occur in the coming weeks or months. Other indicators such as moving averages, volume, support-resistance levels, oscillators, breakout candles, and reversal candles are typically used in conjunction with A-D to provide a more accurate entry confirmation. Timing is everything when entering a trade. The convergence of various indicators with A-D is critical and

provides the timing for entering the trade. Examples of using A-D in conjunction with other indicators as a means for entering trades is provided later in the chapter.

## Calculation of Accumulation-Distribution by Price and Volume

To provide further insight on how this technical indicator works, we shall look at the formula behind A-D. Specifically, the accumulation-distribution line (or histogram) is derived by taking a portion of daily volume and adding it to or subtracting it from a cumulative volume total. Volume is added proportionally based on where the closing price ends up in relation to the high or low of the day. The nearer the closing price is to the high of the day, the greater the amount of the total daily volume that is added to the running total. Conversely, the nearer the closing price is to the low of the day, the greater the amount of total daily volume that is subtracted from the running total. Nothing is added or subtracted when the closing price falls exactly between the high and the low of the day's range.

Simply put, accumulation-distribution by price and volume is a momentum indicator that correlates price changes and volume by assuming that the stronger the volume, the more significant the price move during any given trading session. Following is the formula for calculating A-D:

$$\text{Accumulation Distribution} = [(\text{Close} - \text{Low}) - (\text{High} - \text{Close})] - (\text{High} - \text{Low}) \times \text{Volume}$$

It is noteworthy that the accumulation-distribution line is similar to the on balance volume (OBV) technical indicator, but with one exception. A-D varies from OBV because only a portion of each day's volume is added to the cumulative total, and it is dependent upon the position of the closing price relative to the high and low of the day (see formula above). On balance volume does not take into account where the price of an ETF closes within its intraday range when determining how much volume to add to or subtract from the cumulative total. Therefore, OBV adds 100 percent of the volume to the running total on up days and subtracts 100 percent of the daily volume from the running total on down days. Consequently, many technical analysts and traders believe that A-D provides a much clearer picture of price and volume action because it evaluates volume relative to price action.

When the accumulation-distribution line is sloping higher, it suggests institutional accumulation (buying) is occurring, and when it is sloping lower it suggests institutional distribution (selling) is present. Therefore, when a *divergence* occurs between the A-D line and price, this implies that the price action may soon reverse. For example, if the accumulation-distribution line is uptrending while the price of an ETF is still downtrending, the price action may soon reverse and go higher since a rising A-D line implies that institutions are accumulating shares, irrespective of the

downward or stagnant price action. Again, once a *divergence* between the two occurs, a "trigger" for a valid trade setup must be used to time the trade entry.

## Introduction to the Relative Strength Index (RSI) Indicator

The Relative Strength Index (RSI) was developed by J. Welles Wilder and first released in his book, *New Concepts in Technical Trading Systems*, in 1978. RSI is a momentum oscillator that measures the rate of change of price changes in a security. The index moves or "oscillates" between zero and 100, with an overbought reading occurring when the RSI line moves above 70 and an oversold reading occurring when the RSI line moves below 30.

When the price of an ETF is moving significantly higher or lower over a short period of time, then the RSI will quickly approach its overbought reading of 70 or oversold reading of 30. Momentum oscillators are considered *leading* indicators to price reversals. Momentum refers to the rate of change in price over a fixed period. The term *oscillator* refers to the fact that the RSI fluctuates between the values of zero to 100.

In his book, Wilder recommended that a 14-period time frame was ideal when using this indicator. Further, as with accumulation-distribution, divergences between the slope of the RSI line and price action can be used as a leading indicator for potential trend reversal.

*The Relative Strength Index is calculated as follows:*

$$\text{RSI} = 100 - (100 - 1 + \text{RS})$$

Where

$$\text{RS} = \text{Average Gain} - \text{Average Loss}$$

Various time periods are used for calculating RSI, which is largely dependent on the preferred time frame of an individual trader. Typically, we use the 14-day period, as we have found it works well for our short- to intermediate-term swing trading time frame. Day traders often use a two- or three-period RSI to identify overbought and oversold levels. For day trading, however, readings above the 80-line and below the 20-line are generally used as an indication of overbought or oversold conditions.

The terms "overbought" and "oversold" are relative to market conditions and the volatility of a particular ETF. For instance, when an ETF is in a powerful uptrend, readings above the 70 level (overbought) can trigger numerous times prior to the ETF actually shifting lower. The same holds true for oversold readings. As a result, in most instances, we place less significance on the first touch of the 70 or 30 levels during significant trends, either up or down. Our research suggests that the most powerful signals occur with the second and subsequent touches of 70- and 30-lines. Further, we have found that higher beta ETFs are capable of riding extreme levels for

many days or even weeks before a turn occurs. Consequently, it is not recommended to use RSI as a timing mechanism for swing trading. As with all momentum-based indicators, a trade "setup" and subsequent price trigger are required as confirmation of a price correction or trend reversal.

As is common for most momentum indicators, RSI tends to provide its most reliable readings when the market or an ETF is range-bound (not in a steady trend). When an ETF is range-bound, by definition, there is no trend and therefore price movements are not as powerful over a given period of time. As a result, the ETF is not prone to the massive moves associated with powerful bull market rallies or fear-driven bear market collapses. The inertia behind powerfully trending markets is difficult to shift once it has been established. This often results in the initial overbought-oversold readings acting more as warning signals (not timing or trade entry signals) that the market is consolidating (taking a rest) prior to the next move higher-lower.

As with accumulation-distribution, divergences between the price action of an ETF and the RSI can also provide a signal that a trend may soon reverse. A bearish divergence occurs when the price of an ETF is moving higher but the RSI is sloping lower. Conversely, a bullish divergence occurs when the price of an ETF is moving lower but the RSI begins sloping higher. In both instances, RSI is not confirming the price action.

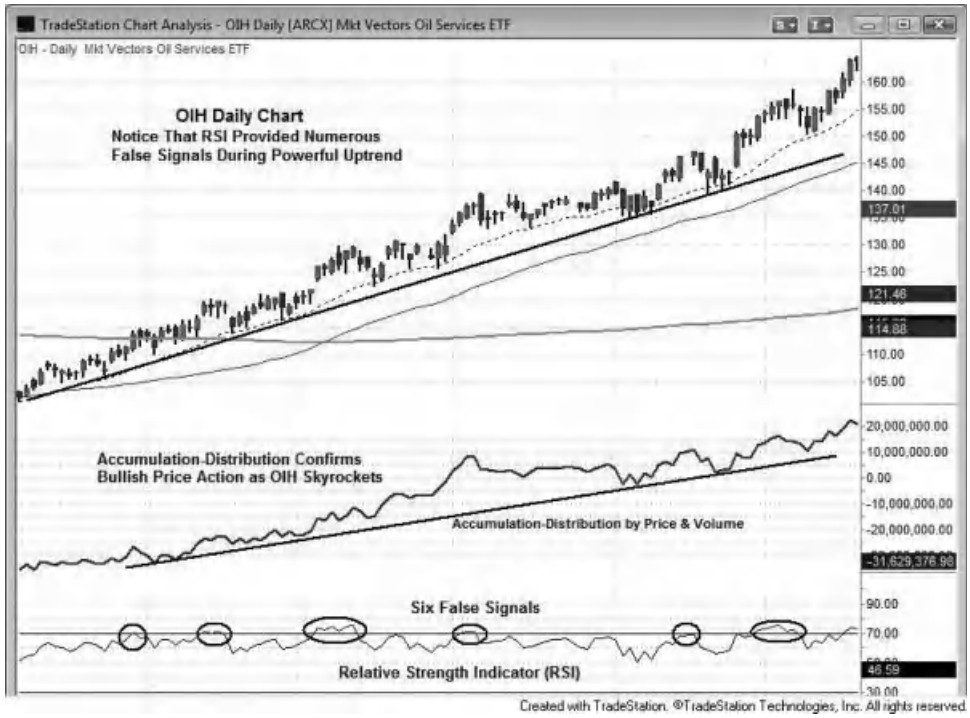
In conclusion, we find the RSI to be an important part of our trading repertoire, but we only use it as leading indicator to possible price shifts. We use RSI in conjunction with accumulation-distribution to further enhance the effectiveness of both indicators. However, we never enter trades based solely on this indicator because many false signals occur. Trades are only initiated when price action confirms the reversal. We wait for a trade setup to occur and a price trigger to be met before entering a trade. As presented in Chapter 3, our trading methodology relies heavily upon candlestick patterns, support and resistance levels, and price action as the mechanism for entering trades.

## Examples—Using A-D with RSI to Aid in Trade Entries

Let's look at several examples to demonstrate how we use A-D in combination with RSI and other technical indicators in our daily trading. When using the A-D and RSI technical indicators, it is helpful to think of them as early warning signals that a reversal may be on the horizon. As discussed earlier, they should never be used in isolation to enter a trade. They are the signal, but the subsequent trade setup provides the entry. We generally use candlestick patterns to identify setups and establish price triggers and stops for entering and exiting trades. This holds true for both long and short trade entries.

Following is an actual trade that we made using RSI in combination with accumulation-distribution (A-D) to refine a trade entry. From August 2010 through April 2011, the Market Vectors Oil Services ETF (OIH) was in a very powerful

**FIGURE 5.1** OIH evaluated using accumulation-distribution with RSI




uptrend. During this uptrend, the accumulation-distribution technical indicator confirmed the bullish price action as it set higher-highs and higher-lows with the trend. However, in Figure 5.1, notice how many times the Relative Strength Index provided an overbought signal. On six separate occasions RSI signaled a turning point, yet OIH continued its march higher. This is exactly why neither RSI nor A-D should be used in isolation as a tool for timing a trade entry. False signals frequently occur during strong trends.

The next chart of OIH (Figure 5.2) shows how A-D can be used to screen out false signals common to RSI. At the highest high set by OIH in the chart, a very important divergence occurred that gave us a signal that OIH was likely to pull back very soon.

On March 1, 2011, and April 6, 2011, ProShares UltraShort Euro (ticker symbol: EUO) set consecutive new swing highs. However, during that same time frame, two important events occurred. The first was that RSI provided a seventh overbought signal. However, what was more important is that, for the first time since the uptrend in OIH began, the overbought signal triggered by the RSI was confirmed by a divergence between A-D and the price action in OIH.

While OIH was setting a higher-high on April 6, 2011, the accumulation-distribution indicator, for the first time since the uptrend began, set a lower high on April 6. *A-D had finally confirmed an overbought signal!* When these two indicators

**FIGURE 5.2** OIH—RSI and accumulation distribution converge


converge, our research indicates that it is likely that a trend reversal will occur shortly thereafter. Once the convergence occurred, we began monitoring OIH for a potential trade setup. As we've discussed, we don't enter a trade provided by a signal; rather, we look for a candlestick formation that will provide a legitimate setup, with at least a 2-to-1 reward-to-risk ratio.

Figure 5.3 is an enlargement of the trade details provided in Figure 5.2. A setup appeared shortly after OIH set its first lower-high in late April. This provided an indication that a trend reversal might be underway.

Once the lower-high was established, OIH sold off and undercut its 20-day EMA and 50-day MA, but then recovered and consolidated above these key marks from April 20 to 29, 2011. On May 2, 2011, our short setup triggered when OIH formed a bearish reversal candle and broke below the seven-day low ($157.27 low set on April 27). We liked the price action that day because OIH gapped up but then sold off the entire day as it lost support. Further, volume increased and the 20-day EMA crossed below the 50-day MA. This crossing of moving averages is also considered bearish.

From that day on, the position never put us under duress or threatened our stop (which was just above the April 27 high of $162.80). We exited the trade when OIH

**FIGURE 5.3** Short entry into OIH


came into support of its 200-day MA on June 20, 2011. As mentioned in our previous book, rarely will an ETF lose support of the 200-day MA on its first test following a protracted uptrend.

The second and final example of using RSI in combination with A-D is for a buy entry we made in the iShares MSCI Mexico Investable Market ETF (EWW) in the fall of 2010.

EWW had been downtrending for several weeks from July through August of that year. On August 25, 2010, EWW set a lower low, but the A-D line set a higher low. This bullish divergence between the price action and A-D suggests that, although EWW was moving lower, it was being accumulated by institutions. Further, the RSI triggered an overbought signal as it touched its 30 level. EWW also formed a bullish hammer candlestick on August 25, 2010. All the pieces of the puzzle were now in place. All that was required now was a buy entry trigger, as shown in Figure 5.4.

On September 1, 2010, EWW provided us with a buy trigger as it gapped above the six-day high on a burst of volume. We set our stop below the low of the reversal candle, with the plan of potentially exiting the trade early if EWW didn't hold the gap. Not only did EWW hold the gap, but it also gapped up for three consecutive days. We raised our stop to just below the September 1, 2010, low and eventually exited the trade on September 23, 2010, at $52.35. We decided to exit the trade at the end of the day because it was apparent that EWW had formed a reversal candle,

**FIGURE 5.4** EWW long entry using accumulation-distribution with RSI


**FIGURE 5.5** EWW trade results

RSI had triggered an overbought signal, and A-D was providing a bearish divergence with the price action in EWW. Ultimately, we exited the trade for the same reasons that we entered it (see Figure 5.5)!

When used in combination with candlestick pattern setups, accumulation-distribution and RSI become very powerful trading tools. When RSI and A-D signals converge, all that is needed is to patiently wait for a setup with a favorable reward-to-risk ratio.

*Advanced Technical Analysis of Etfs: Strategies and Market Psychology for Serious Traders*
by Deron Wagner, Edward Balog


# PART III

# Trade Examples

# CHAPTER 6

# 15 ETFs We Bought

There's no better way to present and reinforce our trading strategies than by walking you through actual past trades we entered using our own capital. On our website, morpheustrading.com, we have been posting the trade results of all ETF (and stock) trade results from our swing trading newsletter, *The Wagner Daily*, since 2002. This means we report the performance of *every* trade, both winners *and* losers. These trades were therefore taken directly from the archives of our site.

In this chapter, we provide you with educational, objective technical analysis of 15 of those actual ETF trades we bought and described in our newsletter sometime in 2010 or 2011. Because we have already provided specific trade examples of how to apply the advanced technical strategies, the trades in this chapter and Chapter 7 seek to illustrate that profitable trading can be achieved simply through following the basics of our top-down ETF strategy. Application of the additional advanced strategies would only serve to enhance one's profitability even further.

For each trade, we will show you a chart of what the setup looked like at the time of entry, and then we will show you another chart with the subsequent outcome. Because most of us learn more from our mistakes than from our successes, we have made sure to include losing trades as well (five of the 15 trades presented here). Regardless of whether a trade was profitable, the educational value is the same. In fact, it is probably safe to say that much more is generally learned from losing trades than from profitable trades. However, don't underestimate the value of carefully analyzing each winning trade for subtle errors that might have prevented you from realizing even more profit from the trade.

## Example 1: Trend Reversal Breakout

The first example is a "trend reversal breakout" setup in PowerShares DB Agricultural ETF (DBA). Throughout the first five months of 2010, this ETF was in a distinct downtrend (Figure 6.1). During the first 3½ months of the downtrend, DBA was unable to reclaim support of its 20-day EMA. Also notice that the 20-day exponential moving average (EMA) crossed and stayed below the 50-day simple moving average (MA) during this time frame.

**FIGURE 6.1** DBA entry setup


However, in mid-April 2010, DBA rallied above the 20-day EMA and attempted, but failed to hold support of both the 20-day and 50-day moving averages. DBA attempted this twice in the month of April. Generally, the first couple of attempts to break above a moving average during a downtrend are unsuccessful, as sellers are plentiful. However, the third attempt often results in a successful trend reversal breakout. DBA also began showing bullish divergence between accumulation-distribution and price action. Further, this ETF had just put together five consecutive up days, the most since the downtrend began in January 2010. Nonetheless, just because an ETF shows signs of a trend reversal, this is not a reason in and of itself to enter a long position. Rather, as our trading rules require, the ETF must first provide a valid setup, a "price trigger," and at least a 2:1 risk-reward ratio to justify an entry in the trade.

The setup in DBA was an eight-day period of consolidation at the 50-day MA, combined with a "false breakout" on June 21. The June 21 price action resulted in a distinct reversal candle on a spike in volume. The high of a shooting star candlestick pattern (June 21) serves as a key point of resistance. If DBA were to reverse trend, the June 21 high provided a quality long entry trigger. Our stop was placed just below the 20-day EMA, and our target was a test of the February 2010 swing high ($25.90 area). Notice that the stop loss was 72 cents below our trigger, and the target was approximately $1.40 above our trigger. Therefore the risk-reward ratio was 2:1 in our favor.

**TABLE 6.1** Actual Trade Result for PowerShares Agricultural Fund (DBA)

| | |
|---|---|
| Entry | Bought: June 30, 2010, at $24.16 (Trigger: $24.51) |
| Exit | Sold: August 2, 2010, at $26.20 |
| Net gain/loss | +2.04 points |

*Source: The Wagner Daily*

Following are the details listed for the trade setup, as listed in *The Wagner Daily* that day; also see Table 6.1, which shows the actual subsequent trade outcome.

PowerShares Agricultural Fund (DBA)—Long
Trigger = $24.51 (above the high of the recent range)
Stop = $23.79 (below the 20-day EMA)
Target = $25.90 area (test of February 2010 high)

Our buy entry into DBA ended up being different from the original setup. Why? We entered the trade in advance of the initial trigger because a new setup had formed. On June 29, 2010, DBA gapped down severely (opened lower than the prior day's closing price), closed near session lows, and was well below its downtrend line. However, on June 30, DBA reversed abruptly to reclaim the downtrend line and 50-day MA. On June 30, DBA formed a bullish reversal candle, so the low of the July 29 candle now provided a legitimate stop loss.

We maintained the trade size of 800 shares, and the dollar value of the price stop was also maintained. The new stop was set at $23.29, and the new entry was $24.07 (78 cent stop just below the June 29 low). Eventually, when DBA hit our original trigger of $24.51, we added to the trade and this resulted in an average entry price of $24.16. Once DBA began losing momentum near its target, we exited the trade with a 2-point profit. The outcome of the trade is shown in Figure 6.2.

This trade provides the lesson that it is important to remain flexible when entering a trade. Just because a trade setup forms doesn't necessarily mean that the trade will trigger as anticipated. Sometimes an alternative setup emerges that also provides a legitimate quality entry. It is important to note that once we added to the trade, we also raised the stop on the entire trade to just below the 20-day EMA (July 7 low), in order to maintain consistent risk.

## Example 2: Trend Reversal Pullback and Reentry

Once a trend reversal is underway, there are plenty of opportunities to reenter the trade as a sequence of higher lows and higher highs are established. Consequently, if the first trend reversal breakout is missed, there is no reason to feel regret and "chase the trade." DBA provides an excellent example of buying into a pullback. Our initial trade exit for DBA occurred on August 2, 2010, when it hit its original target. Knowing that DBA still had significant upside potential since it was in the early stage

**FIGURE 6.2** DBA trade result


**TABLE 6.2** Actual Trade Result for PowerShares Agricultural Fund (DBA) (Reentry)

| | |
|---|---|
| Entry | Bought: August, 12, 2010, at $25.87 |
| Exit | Sold: September 14, 2010, at $27.45 |
| Net gain/loss | +1.58 points |

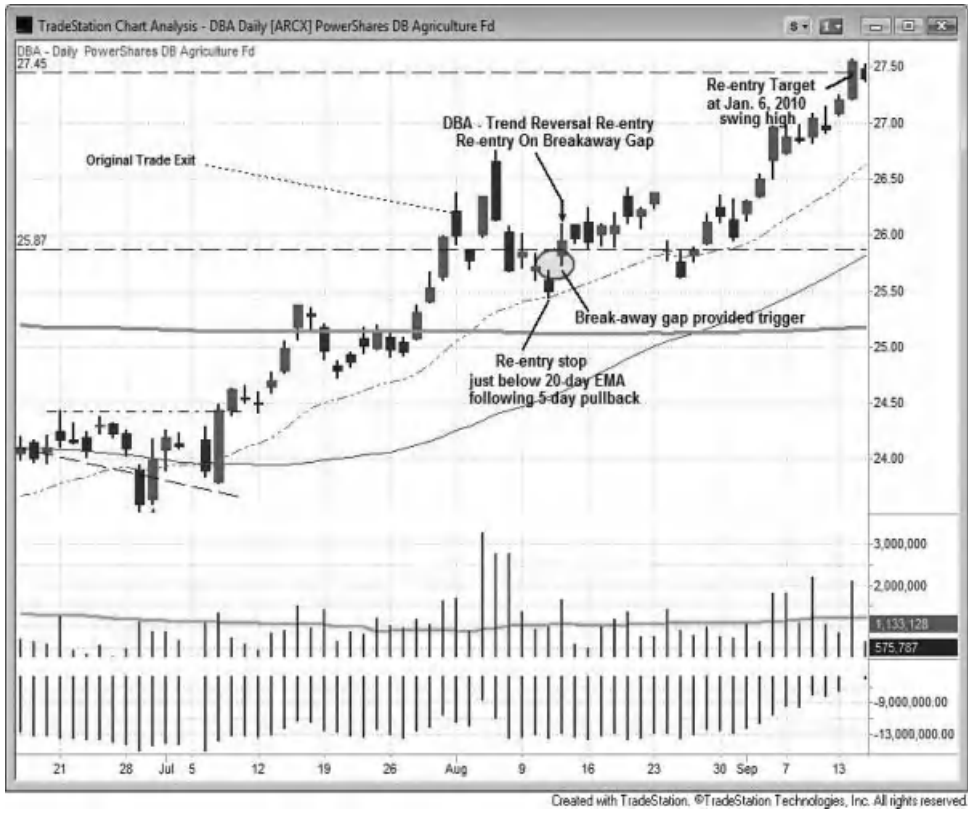
*Source: The Wagner Daily*

of a trend reversal, we waited for a pullback into support as a possible reentry trigger for this ETF (see Table 6.2).

On August 5, DBA stalled out and pulled back for the next five days before finding support at the 20-day EMA on August 11. Now, all we needed to reenter was a legitimate trigger. The trigger was provided on August 12 when DBA formed a "breakaway gap" on a healthy spike in volume (as shown in Figure 6.3).

Breakaway gaps often provide an excellent entry trigger because they catch short sellers off guard and force short covering. The short covering provides further fuel for the rally. Our rule for entering on a gap-up is to wait for the ETF rally above the five-minute

**FIGURE 6.3** DBA reentry




high. We always wait five minutes to avoid getting pulled into false breakouts at the open. The five-minute high confirms the legitimacy of the gap-up. Alternatively, DBA could have formed a legitimate trigger with a sharp undercut of the 20-day EMA and the formation of a bullish reversal candlestick such as a hammer (see Chapter 3 for an example of bullish hammer). A move above the high of the hammer candlestick would provide a buy trigger, and a stop could be placed below the low of the hammer.

We ended up reentering DBA above the five-minute high at a price of $25.87. We placed our stop just below the August 11 low at $24.67, and our target was placed just below the January 6, 2010, swing high at $27.45 (where the former downtrend began).

## Example 3: Trend Continuation Pullback Entry (Unsuccessful Trade)

In the January 21, 2010, issue of *The Wagner Daily*, we remarked that energy ETFs were showing relative strength to the broad market. We commented, "We continue to see bullish setups develop in the energy sector. Most of these patterns . . . are

**FIGURE 6.4** FCG buy setup


currently in pullback mode after a strong run up off the December lows. First Trust Natural Gas (FCG) has held support of the 20-day EMA with two shakeout attempts on Jan. 13 and Jan. 20. Look for a break of the downtrend line as a potential entry point. . . . there could be a few more days of downside before the pullback bottoms out and is ready to move higher." The best setups are often not so clean, as there are usually a few shakeouts to run the stops before the uptrend resumes.

The original setup, in which we planned to buy on a break above the downtrend line, is shown in Figure 6.4.

Although the initial plan was to buy above the downtrend line, Figure 6.5 shows FCG lost support of the 20-day EMA. But by January 26, 2010, FCG appeared to have found support at the more significant 50-day MA. On that day, we entered the trade because FCG had held support of the three-day low and reversed to close in the upper half of the trading range. However, this trade was ill advised and ended up losing money (see Table 6.3).

Figure 6.6 shows the subsequent outcome of our buy entry.

This trade failed on many levels. It is an example of "believing" that an entry existed instead of waiting for a proper setup to form. We entered the trade because we

**FIGURE 6.5** First Trust ISE-Reserve Nat Gas (FCG) entry on Jan. 26, 2010


**TABLE 6.3** Actual Trade Result for FCG

| | |
|---|---|
| Entry | Bought: January, 26, 2010, at $17.53 |
| Exit | Sold: February 4, 2010, at $16.89 |
| Net gain/loss | −0.64 points |

*Source: The Wagner Daily*

thought that it found support when it held the three-day low just above the 50-day MA on January 26. However, this is not a legitimate reason to enter a trade on a pullback. Once an ETF has pulled back, you must wait for a setup to occur. Following a pullback into support, a legitimate setup should have the following characteristics:

1. An undercut of a key support level such as a moving average or a multiday low. This undercut should not result in a loss of support. A distinct reversal candle should form as a result of the undercut. A good example of a reversal candle can be found in the first chart of FCG posted at the beginning of this section (see circled candlesticks on January 20 chart in Figure 6.6). Notice how the price

**FIGURE 6.6** Trade result of FCG


action in both of these candles formed a long bottom wick but closed near the highs of the session.
2. Price consolidation for several days to several weeks, as the ETF sets higher lows within the tight range.
3. Ideally we like to see a false breakout above the range. The false breakout high will often become the price trigger for entering the trade.

As you can see from Figure 6.6, none of the three criteria for a proper setup were met. We witnessed a weak example of a reversal candle on the day we entered the trade (01/26/2010), never saw an undercut of a key support level (such as the 50-day moving average or the three-day low), and there was never any consolidation at the new support level. In fact, we discussed all of these matters in the January 21 issue of the newsletter ("First Trust Natural Gas (FCG) has held support of the 20-day EMA with two shakeout attempts on Jan. 13 and Jan. 20. Look for a break of the downtrend line as a potential entry point"). We simply ignored our own advice. We didn't even wait for a move above the downtrend line. This is a clear example of how *not* to put on a trade.

## Example 4: Building a Base Prior to Breakout

The chart of the SPDR Oil & Gas Exploration ETF (XOP) provides an excellent example of base building prior to a breakout to new highs. In late September 2010, XOP began an uptrend as it broke above resistance of its 200-day MA. Notice how XOP continually found support at the 20-day EMA (dotted line) during the uptrend. Starting in mid-November, XOP stalled out and began consolidating in a tight trading range between $47.50 and $48.50. Figure 6.7 shows the price action in XOP as of November 30, 2011. In our newsletter, *The Wagner Daily*, we set the following trade parameters on that day:

XOP—Long
Trigger = $48.77
Stop = $47.34
Target = New 52-week high (will trail stop)

We further stated, "XOP has maintained excellent relative strength to the market. A rally above the 4 day high of $48.64 makes XOP a potentially ideal long candidate. This ETF is also being placed on the watchlist."

**FIGURE 6.7** XOP buy setup

As it turned out, XOP hit its long entry trigger on December 1, 2010, as it gapped up. On the gap-up, we entered the trade at $48.88 (Figure 6.8). As a side note, we have a rule for entering gap-ups. If an ETF gaps up (or down) more than 1 percent beyond its entry trigger, we do not immediately enter the trade. Instead, we have two options. We can cancel the trade if we feel the gap is too severe, or we wait for the ETF to trade through the five-minute high. The "gap rule" prevents us from

**FIGURE 6.8** Trade result for XOP


**TABLE 6.4** Actual Trade Result for SPDR Oil & Gas Exploration ETF (XOP)

| | |
|---|---|
| Entry | Bought: December 1, 2010, at $48.88 |
| Exit | Sold: December 27, 2010, at $51.95 |
| Net gain/loss | +3.07 points |

*Source: The Wagner Daily*

entering a trade in the melee at the opening bell. False moves are quite common in the first five minutes of trading, hence the phrase, "gap and trap." On the other hand, if the gap-up is less than 1.0 percent beyond our trigger or if the ETF trades through its trigger during the first five minutes of the open, we still wait for the ETF to trade through the five-minute high (or low if shorting).

Ultimately, we exited our position in XOP for a more than 3-point gain (see Table 6.4). Although we were trailing a stop on this trade, we decided to exit the position as it began showing signs of weakness in late December 2010, and it had not tested support of its 20-day EMA in almost a month.

## Example 5: Trend Reversal Long Entry

In October 2010, we entered a long position in the UltraShort Lehman 20+ Year Treasury ETF (TBT). For most of 2010, TBT had been in a severe downtrend (note the trend line, the dashed line, in Figure 6.9). However, in late September of that year, TBT began showing signs of bottoming as volume picked up and it set its first higher-low in early October.

**FIGURE 6.9** Buy entry into TBT

On October 14, 2010, via an intraday e-mail alert sent to the subscribers of *The Wagner Daily*, we bought TBT into the close. We liked the trade because TBT formed a bullish engulfing candle on high volume. Notice how the October 14 candlestick completely overlapped (engulfed) the candlestick formed on October 13. Further, TBT closed near the session high and broke above resistance of the 20-day EMA, 50-day MA, and a multimonth downtrend line (dashed line). See Figure 6.9.

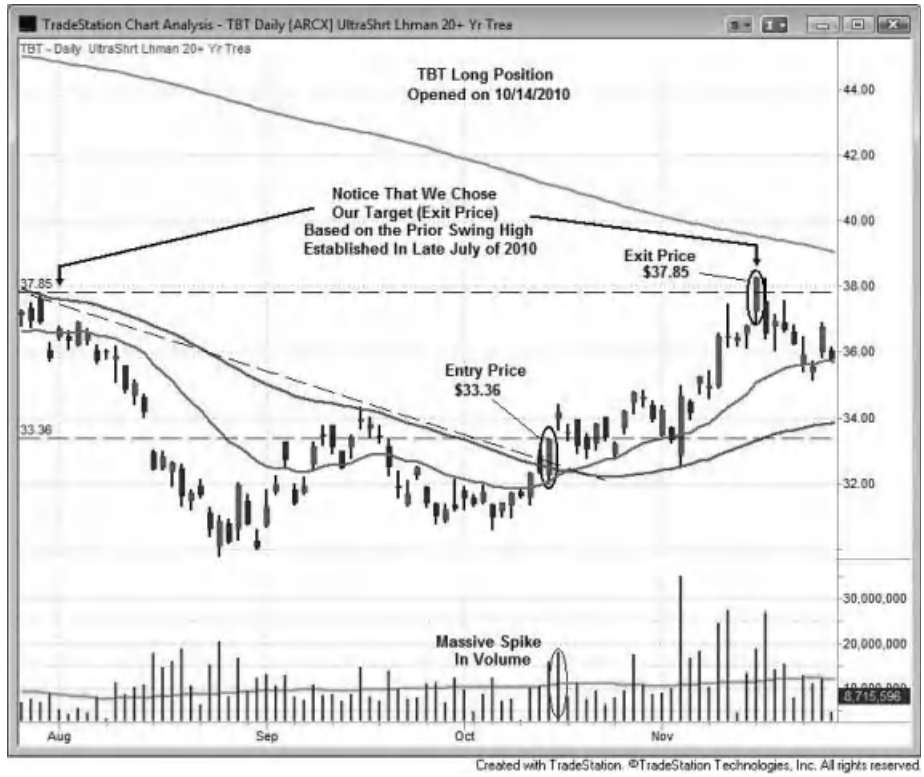
We set the stop on TBT at $31.29, just below the October 12, 2010, reversal candle. With just over a 2-point stop in place, this gave us a reward-to-risk ratio of over 2 to 1. We established the target of $37.85 since it was likely that TBT would find resistance at the prior swing high set in July of 2010. We exited the trade when it hit its target, locking in a gain of 4.49 points (shown in Table 6.5 and Figure 6.10).

**TABLE 6.5** Actual Trade Result for UltraShort Lehman 20+ Year Treasury ETF (TBT)

| | |
|---|---|
| Entry | Bought: October 14, 2010, at $33.36 |
| Exit | Sold: November 15, 2010, at $37.85 |
| Net gain/loss | +4.49 points |

*Source: The Wagner Daily*

**FIGURE 6.10** Trade outcome of TBT



## Example 6: Trend Reversal Long Entry—Unsuccessful Trade

In November 2010, the ProShares Ultrashort MSCI Brazil ETF (BZQ) was exhibiting signs of a possible trend reversal. On a big spike in volume on November 4, BZQ gapped down and set a new low. However, the new low just undercut the previous low set on October 13. Within three days, BZQ rallied sharply.

On November 16, this ETF saw a major increase in volume, gapped above the 50-day MA, and traded above this mark for eight consecutive days. Further, BZQ had been consolidating above the downtrend line that had been in place since May 25, 2010. We felt that if BZQ could rally above the November 23 high of $18.04, it would present a potential buying opportunity. We placed BZQ on the watchlist in our newsletter, *The Wagner Daily*. The trade details on that date are posted below (as annotated in Figure 6.11).

BZQ—Long
Trigger = $18.09
Stop = $16.67
Target = $19.90

The day that we entered the trade, BZQ formed a bearish reversal candle. The move above the eight-day high proved to be a false breakout. The next day, BZQ undercut the November 29 entry candle but managed to close reverse and close

**FIGURE 6.11** Buy setup in BZQ

**FIGURE 6.12** Trade outcome for BZQ


**TABLE 6.6** Actual Trade Result for ProShares Ultrashort MSCI Brazil ETF (BZQ)

| | |
|---|---|
| Entry | Bought: November 29, 2010, at $18.13 |
| Exit | Sold: December 1, 2010, at $16.66 |
| Net gain/loss | −1.47 points (Loss) |

*Source: The Wagner Daily*

higher for the session. One day later, BZQ formed a breakaway gap and hit its stop (see Figure 6.12 and Table 6.6).

Even if BZQ didn't hit the stop loss, it is very likely that we would have exited the trade due to the severity of the gap-down. As soon as we close out a trade, whether it is profitable or not, we psychologically move forward. Other than evaluating the trade to determine that we followed our trading rules, our focus shifts to the next potential opportunity.

There was an important lesson we took from this trade. In retrospect, we should have waited for a definitive "higher low" to have formed. The pullback into the 20-day moving average from the first test of resistance at $18.04 was too quick. Without a clear "higher-low" in place, we entered the trade a bit too early.

## Example 7: Trend Continuation Long Entry

In late January 2010, the First Trust Dow Jones Internet ETF (FDN) undercut the 50-day MA, but held support as it formed numerous reversal candles (see Figure 6.13). We noticed that FDN was consolidating at the 50-day MA for 10 sessions and decided that it offered a potential long entry above the 10-day high of $35.51. ETFs that consolidate at key moving averages during a trend will generally resume the direction of the current trend once they break above resistance (below support in a downtrend). We placed FDN on the watchlist in *The Wagner Daily* with the following parameters:

FDN—Long
Trigger = $35.51
Stop = $34.58
Target = $37.45

**FIGURE 6.13** Trade setup in FDN

Notice that once FDN cleared the February 2 high of $35.45, the volume spiked and it quickly moved higher. We exited the trade before it reached its target because volume began drying up and FDN seemed to be losing momentum. Sometimes it becomes a judgment call on when to exit a trade. If market conditions begin to erode or an ETF appears to be losing momentum, it's generally best to take your profits (see Table 6.7 and Figure 6.14).

**TABLE 6.7** Actual Trade Result for First Trust Dow Jones Internet ETF (FDN)

| | |
|---|---|
| Entry | Bought: February 4, 2011, at $35.51 |
| Exit | Sold: February 14, 2011, at $36.76 |
| Net gain/loss | +1.50 points |

*Source: The Wagner Daily*

**FIGURE 6.14** Trade outcome for FDN

## Example 8: Trend Continuation Long Entry—Unsuccessful Trade

In late January and early February 2010, we were carefully tracking the iShares Nasdaq Biotech Fund (XBI), as it was showing strength relative to the broad market. At the time, XBI was the *only* ETF on our list of 300 ETFs that was trading at a new 52-week high. By February 1, 2010, XBI had spent its 18th straight trading session in a tight 2-point trading range. Further, the consolidation occurred after a big breakout move that began on December 21, 2009. A month of consolidation in the wake of a thrust higher is ideal price action for a potential long entry. Here are the trade details at the time of entry:

XBI—Long
Trigger = $74.47
Stop = $72.79
Target = $77.85

On February 2, 2010, XBI rallied above its four-day high on a massive spike in volume. In the February 3 issue of our newsletter, *The Wagner Daily* (commentary for all newsletters covers the previous day's market action), we discussed the relative strength in XBI and stated, "Notice that volume during yesterday's breakout surged to more than 300% its average daily level, a sign of institutional accumulation." We posted the chart in Figure 6.15.

We went on to say,

> With at least one day of higher volume gains on the board, traders may now be slightly more comfortable with dipping a toe in the long side of the market. If looking for a new ETF to buy, in anticipation of a possible short-term bottom in the market, XBI may be your best bet. Now that there is no overhead price resistance to contend with, XBI may have the best odds of continuing higher in the near-term, if the broad market doesn't suddenly fall apart again. If buying XBI, we have two points for consideration: 1.) It is not a good environment to chase ETFs that are extended much beyond their breakout levels. Therefore, one might patiently wait for a small pullback, to the area of yesterday's breakout level (around $56.50 to $56.75), before buying XBI. 2.) As with all new long entries right now, one should consider reducing share size to about 50% of normal share size, in order to limit capital risk while the market is still in correction mode.

On February 3, 2010, via an intraday alert to our members, we opened a long position in XBI on a pullback to support of the breakout level ($59.60). In that evening's newsletter (February 4) we provided the following analysis:

> . . . With XBI, we were looking for a pullback to near the area of the preceding day's breakout level. A little more than an hour after yesterday's open, that ideal entry point was provided to us. On the daily chart [Figure 6.16], notice how yesterday's low in XBI nearly perfectly coincided with new support of the breakout above the September 2009 high.

**FIGURE 6.15** Trade setup in XBI


**FIGURE 6.16** Follow-up price action after entry

When looking for a more precise entry point than a daily chart can provide, we frequently drill down to the 15-minute intraday time frame. When a stock or ETF convincingly breaks out on strong volume, as XBI did on February 2, 2010, the first subsequent touch of the 20-period exponential moving average on the 15-minute chart (20 EMA/15 min) often provides a secondary buy point for traders who did not buy the initial breakout.

On the 15-minute chart in Figure 6.17, notice how XBI merely "undercut" its 20 EMA/15 min by a few cents, then reversed higher throughout the rest of the day. It was during that "undercut," at $56.90, that we bought XBI. Conveniently, the 20 EMA/15 min converged with support of the daily breakout level, as shown in Figure 6.16. The 15-minute chart of XBI details the intraday price action of February 3, 2010.

Unfortunately, the trade in XBI didn't work out as planned. Figure 6.18 shows the results of that trade (as shown on Table 6.8).

While reviewing this trade, we came to the conclusion that we could have managed this trade better. Although we waited for a pullback to enter the trade on February 3, we actually missed the better entry for XBI on February 2. We should have initiated the trade on February 2 above the five-minute high (around $56.15). When a gap-up occurs, we always wait for the ETF to trade through the five-minute high in order to avoid getting sucked into a bad trade. We do this because in the first five minutes of trading, price action is often unpredictable and eventually reverses. The obvious entry point of $56.15 was above resistance of the four-day high ($54.99).

We did not enter the trade on February 1, 2010, because we failed to set an alert, and this is in violation of our trading rules. Consequently, we took a decent but less

**FIGURE 6.17** 15-minute intraday chart of XBI

**FIGURE 6.18** Trade outcome for XBI


**TABLE 6.8** Actual Trade Result for First Trust Dow Jones Internet ETF (XBI)

| | |
|---|---|
| Entry | Bought: February 3, 2010, at $56.90 |
| Exit | Sold: February 4, 2010, at $55.28 |
| Net gain/loss | −1.62 points (loss) |

*Source: The Wagner Daily*

favorable entry and we ended up paying the price. We cannot blame ourselves that the price action in XBI reversed so suddenly, but we clearly took on additional risk by not getting in on February 2. Had we done so, we would have still stopped out of the trade, but the loss would have been miniscule.

## Example 9: Trend Continuation Long Entry

From December 2010 through early February 2011, the iShares S&P SmallCap 600 Growth ETF (IJT) had been consolidating in a $2.50 trading range. In late January

2011, IJT undercut its 20-day EMA and briefly tested support of the 50-day MA. IJT then quickly rallied back above the 20-day EMA. Sharp undercuts of key moving averages often serve to shake "weak hands" out of the trade and sweep poorly placed stops. We set our buy trigger just above the two-month consolidation zone. The trade details are shown in Table 6.9 and the technical setup is shown in Figure 6.19. Trade details at that time are listed below:

IJT—Long
Trigger = $74.47
Stop = $72.79
Target = $77.85

**TABLE 6.9** Actual Trade Result for iShares S&P SmallCap 600 Growth ETF (IJT)

| | |
|---|---|
| Entry | Bought: February 7, 2011, at $74.47 |
| Exit | Sold: February 14, 2011, at $76.64 |
| Net gain/loss | +2.17 points |

*Source: The Wagner Daily*

**FIGURE 6.19** Trade setup in IJT

**FIGURE 6.20** Trade outcome for IJT


Within five days of opening this trade in IJT, we exited with a healthy 2.17-point profit (Figure 6.20). Notice that we exited this trade before hitting the target, but we still captured the majority of the move. In trading, it is more important to catch "the meat of the trade" and not hyperfocus on trying to squeeze every last dime out of the position.

## Example 10: Trend Continuation Long Entry

On September 30, 2010, the U.S. Oil Fund (USO), an ETF designed to roughly track the price of crude oil commodity futures, rallied and closed above a long-term downtrend line that began in April of that year. Over the next two weeks, USO rallied into resistance of the 200-day MA but only pulled back modestly from this key level (Figure 6.21).

On October 12, USO formed a reversal candle, which gave us a potential buy entry trigger. Whenever an ETF rallies into a major resistance level but then consolidates near that level, it can be useful to refer to a 60-minute chart for a potential

**FIGURE 6.21** Trade setup in USO


**FIGURE 6.22** Hourly intraday chart of USO


entry trigger (see 60-minute chart in Figure 6.22). The general setup is shown on the daily chart of USO of Figure 6.21. Trade details were as follows:

USO—U.S. Oil Fund Long
Trigger = $36.01
Stop = $34.34
Target = $39.40

Drilling down to the shorter-term hourly chart interval enables us to more clearly see the ideal entry point, in anticipation of USO breaking out and making another leg higher. Take a look at Figure 6.22.

The dashed straight line in Figure 6.22 marks resistance of the hourly downtrend line, which begins with the October 7 high. Notice the downtrend converges with resistance of the October 12 reversal candle high, which also lines up with resistance of the 40-period moving average on the hourly chart. As such, a rally above the October 12 high would correspond to a breakout above several very short-term resistance levels, thereby triggering a valid buy entry. Trade details are shown in Table 6.10.

Notice in Figure 6.23 that once we entered USO, it pulled back and undercut the 20-day EMA before breaking through resistance of the 200-day MA. Our stop

**TABLE 6.10** Actual Trade Result for U.S. Oil Fund (USO)

| | |
|---|---|
| Entry | Bought: October 13, 2010, at $36.09 |
| Exit | Sold: January 1, 2011, at $39.35 |
| Net gain/loss | +3.26 points |

*Source: The Wagner Daily*

**FIGURE 6.23** Trade outcome of USO

was set at $34.34 to take into account this type of price action. For the trade entry to be legitimate, we felt that USO should be able to undercut, but still maintain support at the 20-day moving average.

It is also important to note that, although this was a successful trade, we should have raised the stop loss from $34.34 to just below the two-day high in November. We still would have realized a solid profit at that level, but we could have done so without having to incur the major drawdown that occurred when USO lost support of the 200-day MA in mid-November. We then could have waited for another setup to form and reentered the trade. Remember, you can always reenter a trade.

## Example 11: Pullback Long Entry—Unsuccessful Trade

On February 2, 2011, we sent out an intraday alert to our subscribers of *The Wagner Daily* that we were entering a long position in the Market Vectors Coal ETF (KOL). We liked the setup because KOL was in a long-term uptrend, and it consistently found support of its 20-day exponential moving average for almost five months.

In mid-January 2011, KOL lost support of its 20-day EMA but pulled back into support of the 50-day moving average. Even though KOL lost support of the 20-day EMA, this pullback still offered a buying opportunity. The first test of the 50-day MA following a powerful uptrend will generally provide support when tested for the first time. Further, KOL had been riding along support of its 50-day MA for eight days. It also undercut this key mark on three occasions but each time managed to hold support. These undercuts serve to shake weak hands on the long side of the trade, squeeze shorts, and sweep stops placed too close to support at the 50-day MA.

On February 1, 2011, KOL gapped up and rallied above the eight-day resistance level near $47.25. This breakout occurred on a big surge in volume and carried KOL back above its 20-day EMA. We entered the trade on February 2 into a pullback at $47.72. The stop was placed just below the gap that was formed on February 1, 2011. On February 3, 2011, KOL sold off abruptly and took out our stop. We were out of the trade in one day and realized a 1.1 point loss. Table 6.11 shows the trade details for our entry.

KOL—Long
Trigger = $47.72
Stop = $46.62
Target = $50.00

Figure 6.24 shows the entry.

We evaluate every trade that we enter to ensure that we are following our trading rules and that we learn from our mistakes. In the case of KOL, the big error made was that the stop was set too tight. After breaking below the 20-day EMA for the first

**TABLE 6.11** Actual Trade Result for Vectors Coal ETF (KOL)

| | |
|---|---|
| Entry | Bought: February 2, 2011, at $47.72 |
| Exit | Sold: February 3, 2011, at $46.62 |
| Net gain/loss | −1.1 points (loss) |

*Source: The Wagner Daily*

**FIGURE 6.24** Trade setup for KOL


time in four and a half months, it is typical that this level will be tested following the first reversal move higher. Further, our trading system relies heavily on placing stops just below prior swing lows.

In Figure 6.25, notice that the prior swing low, which occurred on January 28, 2011 ($45.16), was tested on three subsequent occasions, and KOL found support at this level every time. It is also arguable that we didn't allow KOL to establish a significant enough base following the sharp pullback into the 50-day MA. Eight days was not a very long consolidation period. The most reliable breakouts from bases (consolidation levels) are typically formed over 15- to 30-day periods. In this example, however, had we just set the proper stop, the trade would have been

**FIGURE 6.25** Analysis of KOL trade outcome


successful. KOL never undercut the swing low and it eventually reached its target on March 25, 2011.

## Example 12: Trend Reversal Long Entry

In the September 8, 2010, issue of *The Wagner Daily* we stated,

> In recent weeks, we've been discussing the impressive relative strength various international ETFs have been exhibiting to the U.S. markets, most of which are emerging markets ETFs. Along with the increased appetite for exposure to equities in emerging markets, institutions have also been hot on emerging market debt exposure. The iShares Emerging Markets Bond Fund (EMB), for example, trended very steadily higher throughout July and August. As it was doing so, we put it on our radar screen to monitor for potential buy entry on a correction. Now, it has finally retraced from the high of its impressive run, and may soon provide us with a low-risk pullback entry point.

**FIGURE 6.26** Trade setup for EMB


Here were the trade details at time of entry; the daily chart of EMB is shown in Figure 6.26:

EMB iShares Emerging Market Bond Fund—Long
Trigger = $109.34 (above the Sept. 9 high)
Stop = $107.65 (below support of the 50-day MA)
Target = new high (will trail stop)
Dividend date = October 1

We liked the trade because the the 20-day exponential moving average (the top line) was providing solid support during the retracement off the high. Notice that this was the first touch of the 20-day EMA since the early July breakout that kicked off the impressive uptrend. As explained in our book, *Trading ETFs: Gaining an Edge with Technical Analysis*, the first retracement to the 20-day EMA of a strongly trending ETF usually becomes a great secondary entry point if a long position in the initial breakout is missed. Waiting for the pullback prevents the ill-fated error of "chasing a trade." Often, the first touch of the 20-day EMA is the only chance traders get to participate in the next leg of the trend, in this case a potential leg higher. Typically, the stronger the trend preceding a retracement to the 20-day EMA, the more likely it will resume shortly thereafter.

In our newsletter, we initially discussed EMB as a buy entry above the September 3 high of $110.29. We felt that a rally above this key mark would lead to another round of new highs in EMB. However, we decided on an alternative entry when

EMB held the two-day low on September 9, 2010, amid a massive spike in volume. We modified the setup and set a new entry trigger at $109.34, with a stop just below a major support level at the 50-day MA. Given the massive volume that flowed into EMB on September 9, we felt confident that this level would likely hold. As a bonus, EMB was enticing since it had been paying monthly dividends of approximately 45 cents per share during that time frame. However, only rarely do we consider dividends as part of our trade strategy. Table 6.12 shows the trade details for EMB, while Figure 6.27 shows the outcome of the trade.

**TABLE 6.12** Actual Trade Result for iShares Emerging Markets Bond Fund (EMB)

| | |
|---|---|
| Entry | Bought: September 13, 2010, at $109.34 |
| Exit | Sold: October 14, 2010, at $113.40 |
| Net gain/loss | +3.94 points |

*Source: The Wagner Daily*

**FIGURE 6.27** Trade outcome for EMB

Although it took 10 days for EMB to rally above the original trigger price of $110.29, the September 8 low was never threatened. From the entry point forward, EMB either consolidated or moved higher, until our price target was met on 10/14/2010. The price target was a result of a trailing stop that we put in after the big move up on 10/05/2010. We trailed at stop at 10 cents below the previous day's low until it was finally hit on 10/15/2010. We actually exited the trade slightly ahead of the stop on September 14 because EMB was demonstrating significant relative weakness that day, and we felt it was prudent to take profits. In our opinion, it is perfectly acceptable to take profits ahead of a stop, if market conditions warrant doing so. This holds particularly true in choppy markets and after significant run-ups.

## Example 13: Trend Reversal Long Entry—Unsuccessful Trade

On July 13, 2011, via an intraday alert to our newsletter subscribers, we opened a long position in the PowerShares DB US Dollar Bull ETF (UUP). At the time, we liked the trade because it had been forming a nice basing pattern for nearly three

**FIGURE 6.28** Trade setup in UUP

months after breaking out of a long term downtrend in mid-May. Further, UUP had pulled back into support at its 20-day EMA and 50-day MA after rallying above these key marks for the third time. We have found that when an ETF has tested a resistance level three times, it generally holds support at the former resistance level. As you will soon see, in this trade in UUP, this rule did not hold true to form. We stated in the newsletter, "(We) anticipate that UUP will consolidate for several days prior to seeking higher ground." Below are the trade details at the time of entry. Figure 6.28 shows the trade setup.:

UUP—Long
Trigger = $21.48
Stop = $21.08
Target = New swing high

There are two charts of UUP shown in Figures 6.29 and 6.30. Figure 6.29 shows the actual trade (with results) and Figure 6.30 shows how we should have entered the trade. We could have mitigated our losses had we waited for the proper setup.

In retrospect, we should have waited for a reversal candle to form before entering the trade. Reversal candles "anchor" the trade because they represent the point at which the bulls gained control and the bears lost momentum. They provide a logical and generally tight stop. What's interesting about this trade is that we would have

**FIGURE 6.29** Trade outcome of UUP

**FIGURE 6.30** More ideal entry into UUP


**TABLE 6.13** Actual Trade Result for Powershares DB Dollar Bull (UUP)

| | |
|---|---|
| Entry | Bought: July 13, 2011, at $21.48 |
| Exit | Sold: July 21, 2011, at $21.08 |
| Net gain/loss | −0.40 points (loss) |

*Source: The Wagner Daily*

had a worse entry but it would have been offset by a better stop. The tighter stop would have taken us out of the trade with a much smaller loss. The loss would have been around 25 cents rather than 40 cents (see Table 6.13). The appropriate trade entry and stop should have been around $21.54 and $21.20, respectively.

## Example 14: Trend Reversal Long Entry

On September 1, 2011, the ProShares UltraShort Euro ETF (EUO) broke above its downtrend line that had been in place since June 2010. Then, on a massive burst in volume on September 6, 2011, EUO formed a breakaway gap and established a higher high (compared to the August 8 high—see Figure 6.31).

In the September 7 edition (premarket) of *The Wagner Daily* we commented, "If EUO can put in place a higher low on its next pullback, we are likely witnessing a trend reversal in this ETF. We will be monitoring EUO closely for a potential long

**FIGURE 6.31** Trade setup in EUO


entry." Further, we discussed the bullish action in the ProShares UltraShort Euro ETF (EUO), stating that we might be witnessing a trend reversal.

On Wednesday, September 7, this ETF pulled back, and it appeared likely that it would fill the gap created on September 6 (see Figures 6.31 and 6.32). Consequently, we placed EUO on the watchlist in *The Wagner Daily*. The trade details from that day's newsletter are posted below.

EUO—Long (September 7 Premarket)
Trigger = $17.32
Stop = $16.79
Target = $18.30
Dividend date = n/a

Note that this setup never triggered, and you will soon see why.

As is apparent from the September 7 chart (Figure 6.32), our plan on entering EUO into a pullback seemed likely to occur. Notice that EUO not only pulled back, but also closed at the low of the session and below the September 6 gap-up low. However, in trading, things don't always work out as planned. The next chart of EUO (Figure 6.33) demonstrates this clearly.

Notice that on September 8, EUO once again gapped up. This violent price reversal provided the opportunity to open a long position in EUO once it rallied above

**FIGURE 6.32** Price action in EUO one day later


**FIGURE 6.33** Trade outcome in EUO

**TABLE 6.14** Actual Trade Result for ProShares UltraShort Euro ETF (EUO)

| | |
|---|---|
| Entry | Bought: September 8, 2011, at $17.78 |
| Exit | Sold: September 9, 2011, at $18.61 |
| Net gain/loss | +0.83 points |

*Source: The Wagner Daily*

the two-day high ($17.81). EUO did in fact rally above $17.81, but we were able to get a slightly better fill as it pulled back (actual entry shown in Table 6.14).

When an ETF closes at the low of the day, as it did on September 7, and then gaps up the next morning and takes out the two-day high, clearly there is a major move at hand. The dynamics of this price action are very important.

First, on September 6, bears were caught off guard as EUO gapped up and ripped higher. However, the next day (September 7) EUO *gapped down* and sold off to close at the low of the day. Further, it traded in a wide range. Wide ranges are important because they signal that there is commitment behind the move.

The gap-down, relentless intraday selloff, wide trading range, and close at the lows all combined to pull bears back into the trade. This is important because the next day, September 8, 2010, EUO not only gapped higher but it also gapped to the two-day high on bigger volume. In the blink of an eye, all of the momentum had shifted in favor of market bulls. The short squeeze was on. Anyone short EUO (long the euro) was in big trouble and had to cover quickly.

This fueled a powerful advance on September 8 and an even more powerful move on September 9. Within one day of taking on the position, EUO traded within 20 cents of its target. We made a logical judgment call and exited the trade into strength, slightly ahead of the planned target.

This trade not only demonstrates the importance of having a plan in place, but also provides an excellent example of modifying a trade entry when a new setup presents itself. It also demonstrates the importance of being able to think quickly. We find it useful to visualize various scenarios that might play out when a trade is setting up. By doing this, you are much less likely to get caught off guard when an opportunity different from the one that you envisioned occurs.

## Example 15: Reentering a Recent Winner

Without question, a good trader is always mindful of extended rallies or selloffs. But all too often we find that traders are of the mindset, "This trade is overextended." We'll hear things like, "I wish I had gotten in that one but now it's too late." In reality, this is quite often a result of fear or regret overwhelming good technical trading practices. We believe that every trade stands on its own merits. If a setup is

legitimate, then trade it. That's why they are called trends. It sounds obvious, but the reality is that many traders often ignore the obvious. With this in mind, let's take a look at our next trade example.

On September 15, 2011, we opened another long position in EUO via an intraday alert to subscribers of *The Wagner Daily*. We decided to reenter EUO because it had filled the gap formed on September 9, 2011, and sold off into an important support level. Further, it undercut this level. Undercuts serve to sweep poorly positioned stops and to shake "weak hands" out of a trade. Figure 6.34 shows an example of a "shakeout."

Our trigger of $17.98 was hit and we placed a wide stop just below the 50-day moving average. Although EUO was showing relative strength for quite some time, we used a wide stop since it had just recently rallied above a six-month consolidation zone (see Figure 6.35). Following initial breakouts from consolidation, an ETF will often pull back into the consolidation zone, but instead of acting as resistance, the zone will now act as support. The same holds true for the uptrending 20-day and 50-day moving averages. Nonetheless, we knew that EUO could continue to see selling pressure, given the magnitude of the gap-down (also volume spiked). But we

**FIGURE 6.34** Trade setup in EUO reentry

**FIGURE 6.35** Reentry point into EUO


also knew that the breakout line ($18.04) could easily provide strong support (review Figures 6.34 and 6.35). Here were the trade details at the time of entry:

EUO—Long
Trigger: $17.98
Stop: $17.13
Target: Trailing stop

On September 16, 2011, EUO ended up holding support at the six-month breakout zone, as it gapped up and closed just above its 200-day moving average. A few days later we raised our stop to just below the 20-day EMA as EUO moved higher. On September 22, 2011, we exited the trade into a gap-up (see Figure 6.36). As discussed in our first book, *Trading ETFs*, we always try to sell into strength, particularly if a trade is showing signs of weakening (exit shown in Table 6.15).

**FIGURE 6.36** Trade outcome of EUO reentry


**TABLE 6.15** Actual Trade Result for ProShares UltraShort Euro ETF (EUO) Reentry

| | |
|---|---|
| Entry | Bought: September 15, 2011, at $17.98 |
| Exit | Sold: September 22, 2011, at $19.17 |
| Net gain/loss | +1.19 points |

*Source: The Wagner Daily*

As traders, we trade to make money. However, it the heat of the battle it's often easy to find yourself afraid to enter a good trade. When a trend is in place, you must take advantage of it. There's no sense in having a trading plan if you are don't use it. As long as the trade is sized properly, a legitimate setup (trigger) presents itself, and the appropriate stops are in place, then you owe it to yourself to trade with confidence.

*Advanced Technical Analysis of Etfs: Strategies and Market Psychology for Serious Traders*
by Deron Wagner, Edward Balog


# CHAPTER 7

# 15 ETFs Sold Short

## Selling Short the Market—A Different Mindset

Although many technical short-selling setups are similar to technical long setups (just in reverse), trading the short side of the market is quite different from trading the long side. In particular, market rallies occur over much longer time periods than market pullbacks. Statistically, bull markets endure much longer than bear markets. For instance, it took from late 1982 until late 2007 for the Dow Jones Industrial Average to break above the 10,000-point mark and rally to its all-time high around 14,200. However, in a mere 18 months the Dow plunged 55 percent to 6,470. What took 25 years to build was cut in half in just 18 months (see Figure 7.1).

This brings into focus how much more powerful fear is than greed. The obvious point is that selloffs occur quickly. When swing trading the short side of the market, it is therefore important to get in and out of trades quickly. Further, if short trades are not in your favor very soon after entering them, it's generally better to get out of the trade than to run the risk of a "short squeeze" (a sharp countertrend rally driven by institutions that forces short sellers to cover their positions). Having briefly covered this important distinction between going long and going short, let's take a look at 15 actual short trades entered in *The Wagner Daily*.

## Example 1: Trend Reversal Short Entry

In the January 5, 2011, issue of *The Wagner Daily*, we commented,

> The Market Vectors Junior Gold Miner ETF (GDXJ) appears to be in danger of losing support. For the second time in the last eight sessions this ETF has closed below the 50-day MA. On December 23rd (2010) GDXJ gapped below the 50-day MA, but quickly recovered and filled the gap on January 3rd (overcut 20-day EMA). Yesterday, GDXJ gapped below the key 50-day MA mark, and formed a very bearish reversal candle. A move below yesterday's low of $37.21 provides a potential short entry in GDXJ.

**FIGURE 7.1** Long-term chart of the Dow Jones Industrial Average


Here are the trade details that were listed for the trade:

GDXJ—Short
Trigger = $37.14
Stop = $39.67
Target = $31.90

There were several things that made this trade appealing. First was that GDXJ had broken a long-term uptrend (see dotted line in Figure 7.2) on a massive gap-down. Notice that GDXJ had begun setting lower highs and lower lows over a 20-day period from the swing high. Second, GDXJ was unable to reclaim support of the 50-day moving average after filling the gap. Finally, on January 4, 2011, GDXJ gapped down for a second time in eight days on a massive spike in volume. High volume is generally linked to institutional distribution.

Although GDXJ did not hit our target, we exited the trade because it was near support of its 200-day moving average (just below $33.00 ; see Table 7.1). The exit point is shown in Figure 7.3.

**FIGURE 7.2** Short setup in GDXJ


**TABLE 7.1** Actual Trade Results—Market Vectors Junior Gold Miner (GDXJ)

| | |
|---|---|
| Entry | Sold Short: January 5, 2011, at $37.14 |
| Exit | Cover: January 26, 2011, at $34.33 |
| Net gain/loss | +2.81 points |

*Source: The Wagner Daily*

## Example 2: Rally into Resistance Short Entry

On May 25, 2011, we entered a short position in the Market Vectors Gold Miners ETF (GDX). Our newsletter commentary was as follows:

> Since its precipitous drop in the first half of this month, GDX has spent the last six sessions rallying its way back into resistance at the 200-day moving average. **Although we anticipate an overcut of this key mark**, we still expect the 200-day MA to present significant resistance and foil any further advance by GDX. Notice that (today's) high water mark for GDX matched precisely with the 200-day moving average. For those

**FIGURE 7.3** Covering GDXJ (exiting short position)


of you unable to short GDX, the PowerShares DB Gold Short ETN (DGZ) could serve as a reasonable proxy. Please note that DGZ is the inverse gold ETF and not an inverse gold miner ETF.

The chart in Figure 7.4 shows the GDX setup the day we entered. Note the text in bold above, as our anticipation of the overcut ended up playing a major role in this trade. You will soon see why.

GDX—Short
(half position)
Trigger = $56.52
Stop = $58.35
Target = Previous swing low (near $53.70)

Table 7.2 shows the trade results for GDX. Notice that we covered this short position into weakness on June 6, 2011, just above support of the prior swing low (Figure 7.5).

A review of the chart in Figure 7.5 provides an important learning experience with respect to visualizing potential trade scenarios and the importance of understanding

**FIGURE 7.4** Short setup for GDXJ


**TABLE 7.2** Actual Trade Results: Market Vectors Gold Miners ETF (GDX)

| | |
|---|---|
| Entry | Sold short: May 25, 2011, at $56.52 |
| Exit | Cover: June 6, 2011, at $54.75 |
| Net gain/loss | +1.77 points |

*Source: The Wagner Daily*

how to manage gap-ups or gap-downs in the market. As you recall, on the day that we entered this trade, we discussed the possibility that GDX would overcut the 20-day EMA before moving lower. In fact, GDX did rally above the 20-day EMA, as it gapped up on both the 27th and 30th of May prior to moving lower. ETFs, stocks, and indexes generally don't turn on a dime. There are stops placed just above/below key resistance/support levels, and market makers know this. They have the book and they are experts at sweeping stops. Further, traders tend to place stops too close to key support/resistance levels, making it all the more profitable for market makers to run through these levels. Because this was an anticipatory entry, we not only took smaller size, but we also placed our stop well above the 200-day moving average.

By anticipating the possibility of an overcut, we were psychologically prepared to deal with it when it occurred. It's easy to get shaken out of a trade when you don't understand the intricacies of potential movements in the market. The market rarely

**FIGURE 7.5** Exit out of GDXJ


gives you what you want. Obviously, it was important that we visualized the potential overcut, as this kept us from getting shaken out of the trade when GDX gapped above the 200-day MA on May 27, 2011. However, what's just as important is that we have a trading rule to deal with the situation when ETFs gap beyond our stop loss, as GDX did on May 30 (we use mental, not physical stops). Despite the fact that our stop was placed well beyond the 200-day MA, GDX gapped up a second time (May 30) and hit our stop. However, we did not exit the trade. We ignored our stop. Why?

We have a "gap rule" in our trading plan. Simply put, when an ETF gaps beyond our stop, we wait for the first 20 minutes of price action to pass, and we place a new stop 15 cents above the high of that candle . . . the 20-minute high (the average is 15 cents, but the stop is adjusted to take into account the price of the ETF). The 20-minute rule prevents us from getting shaken out of a trade due to the unpredictability associated with the market open. However, the 20-minute rule only applies when trading in the direction of the broad market trend.

At the time we sold short GDX, the S&P 500 was also downtrending and had been range-bound for quite some time. If the S&P had been ripping higher and we were shorting GDX, then we would have exited the trade as soon as it hit our stop. However, we rarely trade against the trend, so the 20-minute rule almost always applies.

Had we not anticipated the possibility of GDX overcutting the 200-day MA, and had we not had a trading rule to deal with gaps, this would have been a losing trade.

## Example 3: Rally into Resistance Short Entry

On August 17, 2011, via an intraday alert to our newsletter subscribers, we opened a short position in the iShares Dow Jones U.S. Real Estate Index Trust ETF (IYR). We liked the trade because IYR sold off on a massive spike in volume and lost support of the 20-, 50-, and 200-day moving averages. This sharp round of selling began on July 27, 2011, and did not subside until August 8, 2011. Then, starting on August 9th, IYR began a seven-day rally but on *declining* volume. On August 17 IYR reached its 20-day EMA. As a side note, we also liked the fact that the 20-day EMA provided a bearish signal as it crossed below the 200-day MA. Further, IYR was showing relative weakness to the broad market the day we entered the trade.

We entered a half position in IYR (50 percent of our normal share size) because we were *anticipating* a pullback but did not have a definitive reversal setup at that time. When the market action is in our favor, we will sometimes take partial size trades before a setup forms. Typically, we look for a significant reversal candlestick, such as a shooting star pattern, that has traded at least the one-day average trading range (one-day ATR or ATR), and that significantly overcuts the resistance level (undercut in the case of a long entry) before closing near the low of the day. Additionally, we like to see the reversal candle close below the resistance level, such as a moving average, on a big spike in volume. However, we will only use this strategy when trading in the direction of the predominant trend, and only in ETFs that are exhibiting relative weakness to the broad market.

Particularly in bear markets, where price action is swift, it is sometimes necessary to enter a trade prior to a clean signal (i.e., a reversal candle at a key resistance level) because the market/ETF will sometimes reverse abruptly near key resistance. Naturally, an abrupt move would result in missing the opportunity to enter the trade because the reward-to-risk ratio becomes unfavorable. We only enter trades that provide setups that we believe have the potential of offering a 2 to 1 profit-to-loss ratio. The farther an ETF gaps away from its stop, the greater the risk, since it is unlikely that a 2:1 reward-to-risk ratio is attainable.

Gaps also move the trade closer to the profit target, leaving less room for error. As a result, it is one of our rules to never "chase the trade." We usually consider a gap of greater than 1 percent to be too large, and we therefore do not enter the trade under this circumstance. Again, the reasoning behind this is simple. If an ETF gaps more than 1 percent from the price trigger, in most instances, the reward-to-risk ratio is unfavorable. To do otherwise would require an unrealistic percentage of winning trades for almost any trading model to be successful. Yet, one exception is in the case of higher-volatility ETFs where a 1 percent move is relatively normal.

The ideal short setup is one in which the broad market is in a downtrend, the ETF is exhibiting relative weakness, there's a clear stop out point (such as just above a key

**FIGURE 7.6** Short setup for entry into IYR


moving average, a Fibonacci level, or a long reversal candle), and there is a definable target price that provides at least a 2 to 1 reward-to-risk potential. A legitimate target could be a prior swing low (or a lower-low if the ETF is particularly weak) or a previous support level (i.e., a zone of long-term consolidation that previously served as a base for a breakout). The same setup parameters hold true for long setups, only in reverse. Figure 7.6 shows the IYR trade setup on the day of entry:

IYR—Short
(half position)
Trigger = $56.20
Stop = $57.65
Target = Approximately 50 percent retracement of rally (near $53.70)

The trade results are shown in Table 7.3, and a chart showing the IYR trade outcome is shown in Figure 7.7.

In the case of IYR, the strategy was successful. Notice that on the next day (August 18), IYR gapped down and ultimately closed in the bottom third of the intraday range. If IYR had not gapped down but instead formed an "ideal setup" as described above, we would have taken on a full position by adding to the trade. We generally will not add to trades until they are showing an unrealized gain ("in the

**TABLE 7.3** Actual Trade Result for iShares Dow Jones U.S. Real Estate Index Trust ETF (IYR)

| | |
|---|---|
| Entry | Sold short: August 17, 2011, at $56.20 |
| Exit | Cover: August 19, 2011, at $53.30 |
| Net gain/loss | +2.90 points |

*Source: The Wagner Daily*

**FIGURE 7.7** Exit out of IYR short


money"). We don't always wait for a trade to hit its target, particularly on the short side of the market, where volatility is high. Further, we will sometimes exit a trade before it hits the planned stop, particularly when market or price action in the ETF suggests we should do so.

## Example 4: Short Entry at Resistance

On March 17, 2007, the price action in the broad market began to shift to the short side. Consequently, we lightened up on one of the long positions we had entered in the newsletter and, shortly thereafter, initiated a new short position in the S&P

Metals and Mining SPDR (XME), which showed late-day relative weakness after running into resistance to its January 2010 high. XME also formed a bearish shooting star candlestick (as discussed in Chapter 3), but did so while still trading below its 52-week high. We stated in the newsletter,

> Unlike our recent long entries seeking to take advantage of the market's uptrend, XME was entered as a very short-term, counter-trend trade, with the intention of capturing profits on a pullback to support of its 50-day MA. If we fail to immediately see bearish follow-through in today's session, we will probably just scratch the trade, but a positive reward-risk ratio by having a stop above yesterday's high made XME a decent bet, especially if the broad market now starts to correct as well.

At that time, the broad market had also formed a bearish shooting star candlestick formation. Trade details at time of entry:

XME—Short
Trigger = $57.63
Stop = $59.70
Target = $52.80

As the chart in Figure 7.8 demonstrates, XME provided further appeal as its rally into resistance was on lighter volume than the January 2010 selloff that occurred on much heavier volume. Table 7.4 shows our detailed entry and outcome of the trade, while Figure 7.9 shows our exit on the chart.

Although XME did not hit its target of $52.80, at the time it seemed prudent to exit the trade on the gap down. Further, the broad market began showing signs of strength on March 22, 2010. Going in, we knew this was a countertrend trade.

## Example 5: Rally into Resistance

From the last week of April through the first week of May 2010, the basic materials sector was one of the weakest sectors in the market. Within a nine-day period, it had lost almost 15 percent of its value. In the May 10, 2010, edition of our newsletter, we placed IYM on our watchlist and said,

> If (IYM) rallies into the area of our trigger price ($61.95), there is a ton of overhead supply and resistance levels that will make it difficult to go much higher in the near-term. Our trigger price may not be seen today, if it stays weak enough, but we'll assess price action to determine if a lower trigger price is needed. If any changes are made to the setup, we'll promptly send an Intraday Trade Alert with details.

On May 11, 2010, we made a judgment call to sell short IYM a bit below its original trigger price, due to the continued relative weakness it exhibited during the

**FIGURE 7.8** Short setup in XME


**TABLE 7.4** Actual Trade Results—S&P Metals and Mining SPDR (XME)

| | |
|---|---|
| Entry | Sold short: March 17, 2010, at $57.63 |
| Exit | Cover: March 22, 2010, at $54.35 |
| Net gain/loss | +3.28 points |

*Source: The Wagner Daily*

broad market's midday rally attempt. We notified subscribers of the adjusted trigger price to sell short IYM at market ($61.39). The rationale is shown in Figure 7.10.

The new trigger price was determined by evaluating IYM against the 10-day moving average. When ETFs are in a severe trend (up or down), they will often ride the 10-day MA for extended periods. We didn't want to miss a potential winning entry, so we adjusted our trigger to just below the 10-day MA (see the 10-day MA in

**FIGURE 7.9** Exit in XME short trade


**FIGURE 7.10** Trade setup in IYM

**FIGURE 7.11** Using the 10-day MA as a short trigger


Figure 7.11) with the 10-day MA). Since we knew that we might be entering the trade early, we made no changes to the stop (left it wide) and reduced our normal share size. This was done to maintain risk standards on the trade. Here were the trade details at time of entry:

IYM—Short
Trigger = $61.95 (limit − this price or higher)
Stop = $64.28
Target = $57.20

Notice, in Figure 7.11, that we entered IYM on May 11, 2010, after it failed on its breakout attempt above the May 10 high.

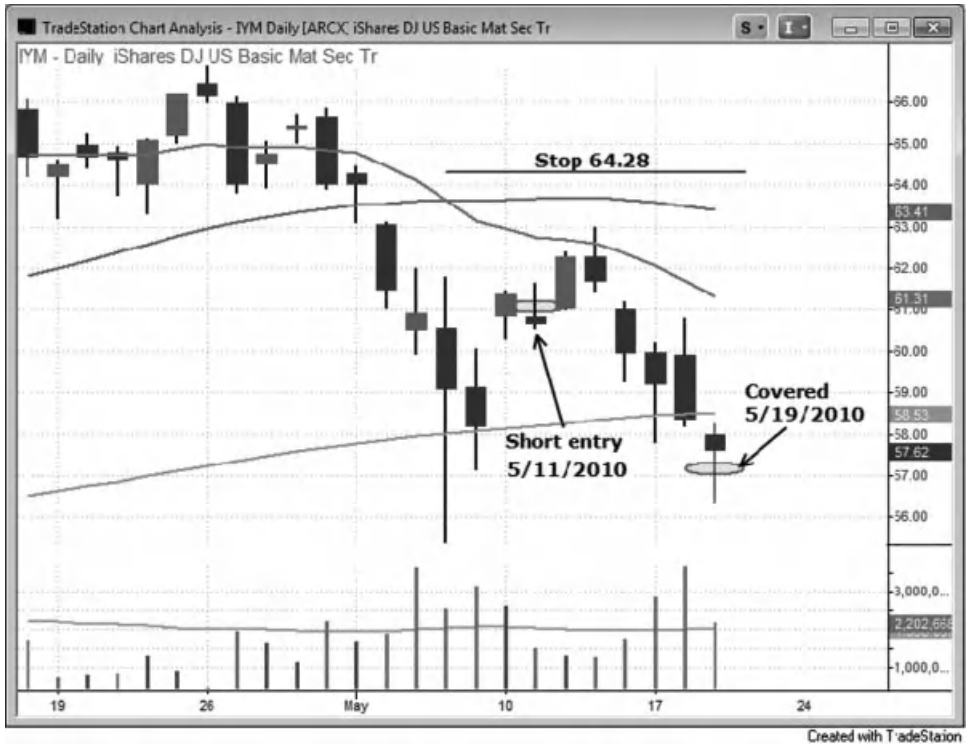
Following our entry, IYM continued to rally and ultimately overcut the 20-day MA before resuming the downtrend. We covered this short position on the May 19 gap-down, below the 200-day moving average and just above our target of $57.20

**TABLE 7.5** Actual Trade Results—iShares Basic Materials Index (IYM)

| | |
|---|---|
| Entry | Sold short: May 11, 2010, at $61.39 |
| Exit | Cover: May 19, 2010, at $57.63 |
| Net gain/loss | +3.76 points |

*Source: The Wagner Daily*

**FIGURE 7.12** Exit out of IYM short trade




(see Table 7.5). This trade could have been added to on a move below the reversal candle that formed on May 13, with a stop placed just above that day's high (Figure 7.12).

## Example 6: Short Entry at Resistance

On May 16, 2010, we entered a short position in USO and provided the following commentary,

> As has been the case for the past few weeks, we're still patiently waiting for U.S. Oil Fund (USO) to rally into major horizontal price resistance of its prior lows, which

> will provide us with the short sale entry point we've been stalking. Still trading well below its 50 and 200-day moving averages, USO continues to show relative weakness to the broad market. Its 50-day MA has also recently crossed below its 200-day MA, another bearish indicator of long-term trend. While USO could probably be sold short on its present bounce, near the current price, we'd ideally like to see a nice probe above the $35 level that triggers stops of traders who sold short near the lows, while attracting the interest of the bulls. At that point, the reward/risk for short selling USO would become quite favorable, as the crowd psychology becomes short-term bullish, but the intermediate and long-term trends remain bearish.

Figure 7.13 shows the area of resistance we had been monitoring for potential short sale. On May 16, USO probed above the $35.00 mark and we entered the trade.

At the time we believed that the near-term, bullish momentum might cause USO to move higher. However, we noted in the newsletter:

> With an abundance of overhead supply to contend with, we believe the bears will soon resume control, causing USO to resume its intermediate-term downtrend.

**FIGURE 7.13** Short trade setup in USO

> If that occurs, we expect USO to at least re-test its May low. But in case USO completely reverses its dominant downtrend, we have a protective stop right above the 200-day moving average, just over the $38 level.

Trade details at time of entry:

USO—Short
Trigger = $35.08
Stop = $38.38
Target = Prior swing low

After our entry, USO put us under minor pressure as it attempted to rally into its 50-day MA. However, this attempt failed and USO eventually gapped down on July 1, 2010. We covered the trade near support of the June 7 low. USO began showing signs of stabilizing at this level, and we believed it was prudent to take profits near a short-term support level. Table 7.6 shows the actual results of the trade, while Figure 7.14 shows the technical exit out of the short position.

## Example 7: Trend Reversal Short Entry

In the June 16, 2008, issue of *The Wagner Daily*, we provided the following commentary regarding the Market Vectors Steel ETF (SLX):

> After trading at its all-time high in mid-May, SLX retraced modestly and began consolidating in a sideways range for two weeks, right at support of its 20-day EMA. Such action should have eventually led to another breakout to new highs, but SLX fell below the low of its consolidation instead. On June 12, SLX closed below its 50-day moving average for the first time in more than four months. The following day's broad market rally pushed SLX back above its 50-day MA, but now it's faced with new resistance of its prior consolidation. [See the dashed horizontal line in Figure 7.15.] Resistance of the 20-day EMA is also overhead. [Just as important as last week's price action] is last week's volume pattern in SLX. On the chart, notice the high volume that occurred from June 10—12, as SLX was selling off. The high volume selling was subsequently followed by light, below average volume when SLX moved back above its 50-day MA on June 13. This tells us that SLX was under distribution last week, which is likely to remain the case this week. As such, there's a

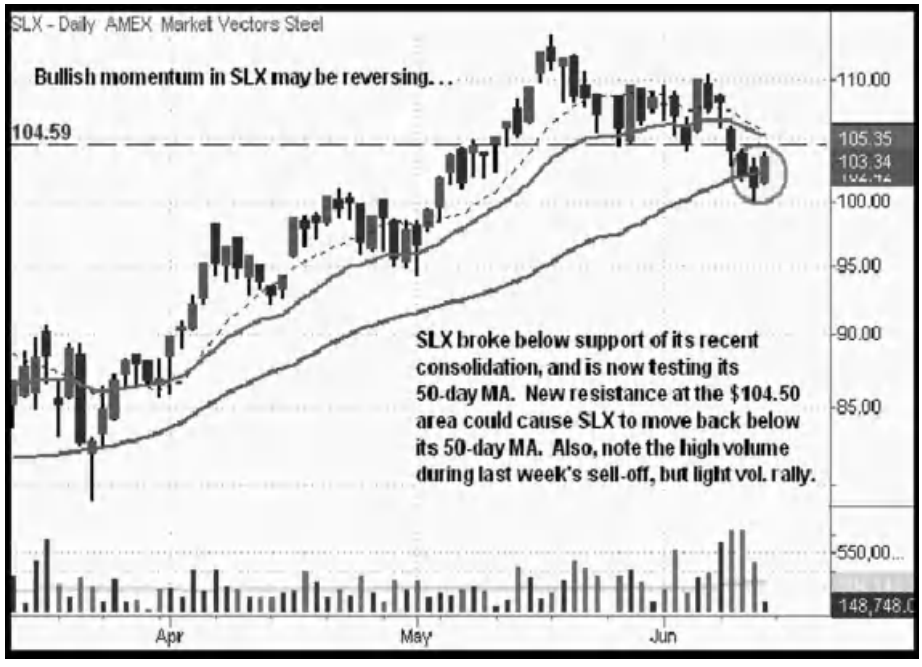
**TABLE 7.6** Actual Trade Results—U.S. Oil Fund (USO)

| | |
|---|---|
| Entry | Sold short: June 16, 2010, at $35.08 |
| Exit | Cover: July 1, 2010, at $32.72 |
| Net gain/loss | +2.36 points |

*Source: The Wagner Daily*

**FIGURE 7.14** Exit out of USO short trade


**FIGURE 7.15** Trade setup into SLX short



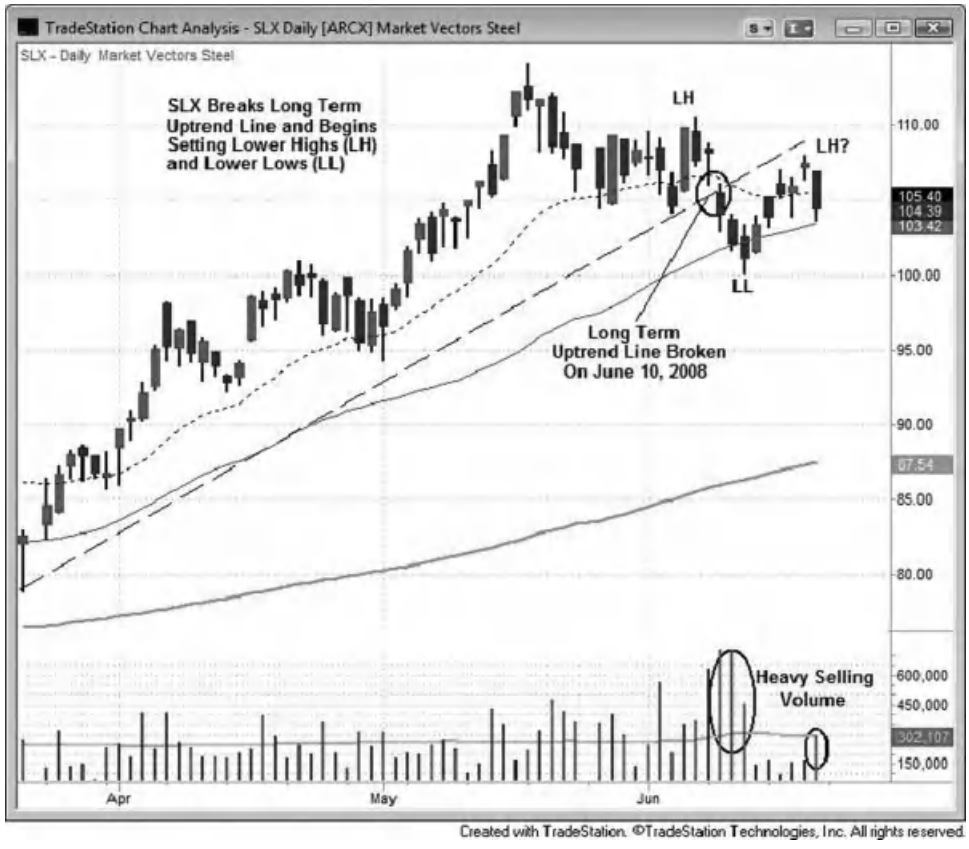
good chance SLX will fall back below its 50-day MA within the next several days. Downside momentum could push SLX sharply lower in the short-term. We plan to initiate a short sale in SLX if/when it breaks below last Friday's intraday low of $101.56.

In the chart in Figure 7.15, SLX lost support of its 20-day EMA, which also happened to correspond with its long-term uptrend line (as shown in Figure 7.16).

However, you will notice that the actual setup turned out quite differently from what we had originally anticipated in our June 16 commentary. Here are the trade details:

SLX—Short
Trigger = $105.52
Stop = $109.32
Target = $91.18

**FIGURE 7.16** SLX begins its trend reversal



Unlike what we had anticipated in our June 16 commentary, SLX actually rallied back above its 20-day EMA and stalled on June 19, 2008, as it formed a doji star–like candlestick pattern. This candle formation was the first clue that SLX might see a reversal. Also, notice that SLX had begun to set a sequence of lower highs and lower lows as it began selling off. Then, on June 20, 2008, SLX gapped down and broke below the 20-day EMA. We sent an intraday alert to our newsletter subscribers that we were selling short this ETF at the market ($105.52; see Table 7.7).

The third chart (Figure 7.17) shows how we managed the trade after entering.

On July 2, 2008, we covered this short on a massive selloff that was accompanied by a surge in volume. As a swing trader, whenever an ETF sells off on a huge spike in

**TABLE 7.7** Actual Trade Results—Market Vectors Steel ETF (SLX)

| | |
|---|---|
| Entry | Sold short: June 20, 2008, at $105.52 |
| Exit | Cover: July 2, 2008, at $93.63 |
| Net gain/loss | +11.89 points |

*Source: The Wagner Daily*

**FIGURE 7.17** Exit out of SLX short

volume and provides a 10 percent intraday gain, you should generally take at least two-thirds of your profits. The market doesn't provide many days like this and greed cannot overwhelm your thinking. When you get a gift, take it and don't look back. If you feel that you might suffer from regret, then maintain a partial position. Remember, you can always reenter the trade into a bounce. Although it may not seem likely during the heat of battle, most ETFs will bounce after a massive one-day selloff. Notice that SLX provided ample opportunity to reenter the trade, as it undercut the 200-day MA and then rallied back toward the 20-day EMA.

## Example 8: Rally into Resistance Short Entry

In the June 8, 2011, newsletter (covering the June 7 trading action), we noticed that TUR had rallied into resistance and provided the following commentary:

> Since losing support of the 20-day EMA on May 6th, the iShares MSCI Turkey Investable Market Index ETF (TUR) gapped up into this key moving average for the first time yesterday. Further, it formed a bearish reversal candle and closed at the low of the day. Today's move back into resistance of the 20-day EMA now places TUR on the table as a possible short candidate. Ideally we would like to see TUR consolidate at the current level for several days and make one more move to challenge resistance at today's high. A second test and reversal off of this high could provide a short trigger for TUR. TUR might also provide a shorting opportunity with a small rally followed by a reversal below today's low. We are monitoring TUR closely for a possible short entry.

See Figure 7.18.

The next day (June 9, 2011), TUR gapped up but then sold off to close below the June 8 low of $62.58. It also hit the short entry trigger of $62.46, but we missed the trade. However, we also got lucky because TUR did not fall apart on June 9, and it still provided a clean entry. In the June 9, 2011, copy of *The Wagner Daily*, we provided the following commentary: "Yesterday, TUR . . . retested the 20-day EMA and reversed to close below Tuesday's low. We are placing TUR on the watchlist. Trade details are available to our subscribers in the watchlist segment of the newsletter," which are also shown below in Table 7.8. Figures 7.19 and 7.20 show the confirmation of the short setup and subsequent exit out of the trade:

TUR—Short
Shares = 300
Trigger = $62.17
Stop = $63.57
Target = $59.55

On June 9, 2011, TUR gapped up and reclaimed its 20-day, but it traded in a very tight trading range. This combination of price and volume action is indicative of

**FIGURE 7.18** Short trade setup in TUR


**TABLE 7.8** Actual Trade Results—iShares MSCI Turkey (TUR)

| | |
|---|---|
| Entry | Sold Short: June 10, 2011, at $62.13 |
| Exit | Cover: June 15, 2011, at $58.92 |
| Net gain/loss | +3.21 points |

*Source: The Wagner Daily*

a "shakeout" reversal (false reversal). It serves to sweep ill-placed stops and suck buyers back into the trade.

On June 10, we finally got our entry as TUR gapped down and hit its short trigger of $62.17. The next day (June 13), TUR gapped up once again, but it was overwhelmed by selling pressure almost immediately. Over the next two sessions, TUR gapped down twice, and on June 15, 2011, we covered the trade as it hit our target.

This trade provides two important lessons. The first is to make sure you set alerts. If we had not set a price alert on our trading software, TUR could have left the station without us. The second is, when you set a stop, honor it. When the setup and reward-to-risk ratio are in your favor, do not allow yourself to be "shaken out of the trade" by minor gapping action. When TUR gapped up on June 9 and June 13, 2011, it would have been very easy to cover the trade. You must fight this psychological urge.

**FIGURE 7.19** Further confirmation in TUR short setup


**FIGURE 7.20** Exit out of TUR short trade

## Example 9: Trend Continuation Short Entry (Rally into Resistance)—Unsuccessful Trade

On February 10, 2011, we entered a trade in the Market Vectors Gold Miners ETF (GDX). We reasoned that "(GDX) appears ready to continue its recently established downtrend." At the time, GDX formed a very bearish engulfing candle (February 9) and closed near session lows. "A move below yesterday's low of $56.10 may provide a short trigger for this ETF." Trade details are in Table 7.9. Figure 7.21 shows the original setup at the time of entry, as Figure 7.22 shows our subsequent short entry into the trade.

**TABLE 7.9** Actual Trade Results—Market Vectors Gold Miners (GDX)

| | |
|---|---|
| Entry | Sold short: February 10, 2011, at $55.82 |
| Exit | Cover: February 11, 2011, at $56.56 |
| Net gain/loss | −0.74 points |

*Source: The Wagner Daily*

**FIGURE 7.21** Short trade setup in GDX

**FIGURE 7.22** Short entry into GDX


GDX—Short
Trigger = $55.82
Stop = $56.56
Target = $51.00

There were two problems with the GDX trade. Although we got stopped out quickly, and our losses were minimal, the stop loss was placed much too tight. The stop loss should have been placed 15 cents above the February 9 reversal candle high ($57.82). This would have resulted in a bigger loss, but the stop that we actually placed was so tight that it didn't even give the trade a chance to work. The second mistake with this trade can be seen in the chart in Figure 7.23. Although GDX was in a downtrend at the time we made the entry, it was only an intermediate term downtrend. The longer established uptrend line, which corresponded with the 200-day MA, was still intact. This was clearly the dominant trend. In a nutshell, we were trading against the more powerful trend.

**FIGURE 7.23** Outcome of GDX trade


## Example 10: Trend Reversal Breakdown at Major Support

In the January 24, 2011, issue of *The Wagner Daily*, we discussed the Guggenheim Frontier Markets ETF (FRN) as a potential short setup. We referenced commentary that we had made in the January 19, 2011, issue as follows:

> The Guggenheim Frontier Markets ETF (FRN) is exhibiting signs of relative weakness and may soon present a shorting opportunity. Yesterday [refers to January 19, 2011], FRN sold off on a sizeable increase in volume [see Figure 7.24]. Further, since mid-November, FRN has been consolidating while the Accumulation/Distribution line has been in a significant downtrend. This bearish divergence suggests institutional selling. A break below $23.50 could provide a short entry trigger for this ETF.

We went on to say that,

> Since that time FRN lost support at $23.50 but did bounce yesterday. This ETF now presents two possible short entries. The first would be a rally back into resistance (just

**FIGURE 7.24** Short setup in FRN


above $23.50) on light volume. The second potential short trigger would be a break below Friday's low [see Figure 7.25]. We like the setup and will be watching it closely for a possible entry.

On January 25, 2011, FRN triggered for short entry and we entered the trade via an intraday alert to our clients. Trade details at the time are shown below:

FRN—Short
Shares = 300
Trigger = $62.17
Stop = $63.57
Target = $59.55

As is evident from Figure 7.23, FRN took the path of "short setup #2," as annotated in Figure 7.25. Table 7.10 shows the actual trade results for our short entry into FRN. Figure 7.26 marks the exit out of the position.

In reviewing this trade, we saw that we actually missed a better entry when FRN gapped down on January 20. When FRN dropped below the January 19 low of $23.48, a legitimate short signal was provided. We missed this entry, but we didn't panic. Instead, we developed a game plan by coming up with alternative entries that FRN might provide over the next several days.

**FIGURE 7.25** Further confirmation for short entry


**TABLE 7.10** Actual Trade Results—Guggenheim Frontier Markets ETF (FRN)

| | |
|---|---|
| Entry | Sold short: January 25, 2011, at $23.06 |
| Exit | Cover: January 31, 2011, at $21.95 |
| Net gain/loss | +1.11 points |

*Source: The Wagner Daily*

On January 25, FRN gave us our entry as it lost support of the three-day low. This setup could have been better managed, but it still presented a good opportunity. Further, we didn't let regret cloud our thinking. Of further importance is the stop we chose for this trade. Since we missed the ideal entry, we placed a tight stop just above the January 25 high. In the event that FRN reversed abruptly, this stop would have gotten us out of the trade with a small loss. Further, we would have been in a position to reenter the trade at a much better price.

The market conditions at the time that we entered this trade also assisted us in taking a more aggressive entry. As we stated in the newsletter on January 24,

> The damage done to market leaders over the [preceding] three sessions will likely take several weeks to repair in order to create a new base for another potential rally.

**FIGURE 7.26** Exit out of FRN short trade


When market leaders lose relative strength caution is warranted. It appears as if money has been flowing out of the Nasdaq, the small-cap Russell 2000 and the S&P MidCap 400, and into blue chip issues. Technology stocks are almost always a leading indicator to market direction. It is generally not a good sign for bulls when money begins moving in this manner after a protracted advance.

## Example 11: Trend Reversal Short Entry—Unsuccessful Trade

On March 7, 2011, we made the following commentary:

The SPDR Series KBW Bank ETF (KBE) reversed sharply on Friday, as it gapped down following a strong gap up and rally last Thursday. This reversal occurred on increasing volume, further compounding the bearishness of the move. A loss of support near $25.75 could result in a further downward pressure on this ETF. KBE is being placed on the watchlist. Details of the setup are available in the watchlist segment of the newsletter. For those of you trading in qualified accounts, taking a long position in the inverse ProShares UltraShort Financials ETF (SKF) offers a possible alternative to shorting KBE.

Trade details for the setup were as follows:

KBE—Short
Trigger = $25.68
Stop = $26.43
Target = $24.20

Figure 7.27 shows the short setup in KBE, followed by the subsequent exit out of the trade in Figure 7.28. On March 7, 2011, we entered KBE as it hit its trigger ($25.68). However, the next day (March 8) KBE gapped up and rallied the entire day to close near session highs. We were stopped out of the trade late that day (see Figure 7.11). The lesson from this trade is obvious: Don't place a trade with a stop that is too tight. As a rule of thumb, on a stock valued between $20 and $50, a stop should never be closer than at least 10 to 20 cents above the nearest swing high and/or moving average. For more volatile stocks, stop placement should be even wider around these key support/resistance levels. This stop was so poorly placed that it deserved to get swept. Further, we had ample opportunity to reenter the trade, but because we had lost on the trade so quickly, we didn't see the potential new setup staring right at us (see Figure 7.29).

**FIGURE 7.27** Short setup in KBE

**TABLE 7.11** Actual Trade Results—SPDR S&P Bank ETF (KBE)

| | |
|---|---|
| Entry | Sold short: March 7, 2011, at $25.68 |
| Exit | Cover: March 8, 2011, at $26.43 |
| Net gain/loss | −0.75 points (loss) |

*Source: The Wagner Daily*

**FIGURE 7.28** Exit out of KBE


## Example 12: Trend Continuation Short Entry—Unsuccessful Trade

On June 1, 2011, we published in the newsletter: "The PowerShares DB Agricultural ETF (DBA) has been struggling to regain its 20-day EMA since mid-March. A volume assisted move back below the three day low of $32.63 could present a shorting opportunity in this ETF." Later that day, we entered a short position in the PowerShares DB Agricultural ETF (DBA). We stated that "[we] liked this trade because DBA had consolidated at its 20-day EMA for three days but failed to close above this key mark as the market was moving higher. Further, DBA formed a reversal candle on Tuesday and had two failed breakout attempts in three days." We set a trigger just below the three-day low and ended up entering the trade at $32.43,

**FIGURE 7.29** Subsequent analysis of KBE


**TABLE 7.12** Actual Trade Results—PowerShares DB Agriculture (DBA)

| | |
|---|---|
| Entry | Sold short: June 1, 2011, at $32.43 |
| Exit | Cover: June 3, 2011, at $33.04 |
| Net gain/loss | −0.61 points (loss) |

*Source: The Wagner Daily*

as per the trade details listed in Table 7.12. Figures 7.30 and 7.31 show the technical trade setup and subsequent exit out of the trade, respectively.

DBA—Short
Trigger = $32.43
Stop = $33.04
Target = $31.34

**FIGURE 7.30** Trade setup in DBA short


**FIGURE 7.31** Exit out of DBA short

Within two days of entering this trade, we were stopped out with a small loss. Although DBA was showing relative weakness at the time we entered the position, no definitive reversal candle had formed, and this undoubtedly contributed to the failure of this trade. The most important thing that we took away from this trade is that you can't "manufacture" a trade when it isn't there. A reversal candle of at least one ATR (average true range) is what was needed to increase the odds of this entry to work. Essentially, we saw a reversal candle when none really existed.

## Example 13: Rally into Resistance

On May 12, 2011, we provided the following commentary to our newsletter subscribers: "Since losing support in mid-March [of 2011] the iShares MSCI Japan Index ETF (EWJ) has fought its way back above the 20, 50 and 200 day moving averages. Over the past ten trading days EWJ has stalled at this level and has tested support at $10.38 three times. A volume fueled move below this key mark could provide a shorting opportunity in this ETF." Table 7.13 shows the trade details at that time. Figure 7.32 illustrates the short setup, Figure 7.33 shows the follow through in the anticipated direction, and Figure 7.34 shows the eventual exit out of the trade.

EWJ—Short
Trigger = $10.35
Stop = $10.79
Target = New swing low

On Friday, May 13, 2011, we sent an intraday alert that we were entering a short position in the iShares MSCI Japan Index ETF (EWJ). Shortly after our entry, EWJ fell abruptly and eventually closed near the low of the session.

Within two days of our entry, we covered EWJ into the gap-down on May 17 for a solid profit. We like covering into significant gap-downs and into weakness, as this helps get a quality order execution price with very little slippage. There's no question that we should have held at least half of this position, but on the short side of the market it's easy to get nervous when solid profits are on the board. However, market conditions were in our favor and EWJ had significant relative weakness at the time. Once the 50-day MA had crossed below the 200-day MA, we should have had more

**TABLE 7.13** Actual Trade Results—iShares MSCI Japan Index (EWJ)

| | |
|---|---|
| Entry | Sold short: May 13, 2011, at $10.35 |
| Exit | Cover: May 17, 2011, at $10.12 |
| Net gain/loss | +0.23 points |

*Source: The Wagner Daily*

**FIGURE 7.32** Short setup in EWJ


**FIGURE 7.33** Follow-through in EWJ

**FIGURE 7.34** Exit out of EWJ short position


confidence with the trade. It was very unlikely that EWJ would reclaim this key mark quickly.

## Example 14: Trend Reversal Short Entry—Unsuccessful Trade

On March 21, 2011, via an intraday alert, we entered a short position in XLF in *The Wagner Daily*. We provided the following commentary in the March 22nd issue of the newsletter:

> The SPDR S&P Financial Select Sector ETF (XLF) gapped-up, rallied into resistance and began exhibiting signs of relative weakness. Consequently, we took a short position in this ETF. XLF was unable to rally above its 20-day EMA and at one point it actually traded down on the day. The massive divergence between the Accumulation/Distribution Histogram and price also contributed to our opinion that XLF represented a good risk/reward as a short entry.

**FIGURE 7.35** Trade setup in XLF short


Over the five sessions leading up to our entry, the price of XLF was moving higher but the accumulation-distribution line was moving lower. This was a sign that institutions were actively selling into strength. Further, XLF was met with stiff selling pressure at the 20-day EMA on March 21. The trade details at time of entry follow, while Figure 7.35 shows the actual trade setup.

XLF—Short
Trigger = $16.31
Stop = $16.67
Target = $15.24

Table 7.14 shows the trade results for XLF. Although this trade was unsuccessful, we believe that it was still a well-managed trade. Sometimes you do everything right, but the trade simply doesn't work. That's why always honoring your predetermined stop losses is critical. Take a moment to review the chart in Figure 7.36.

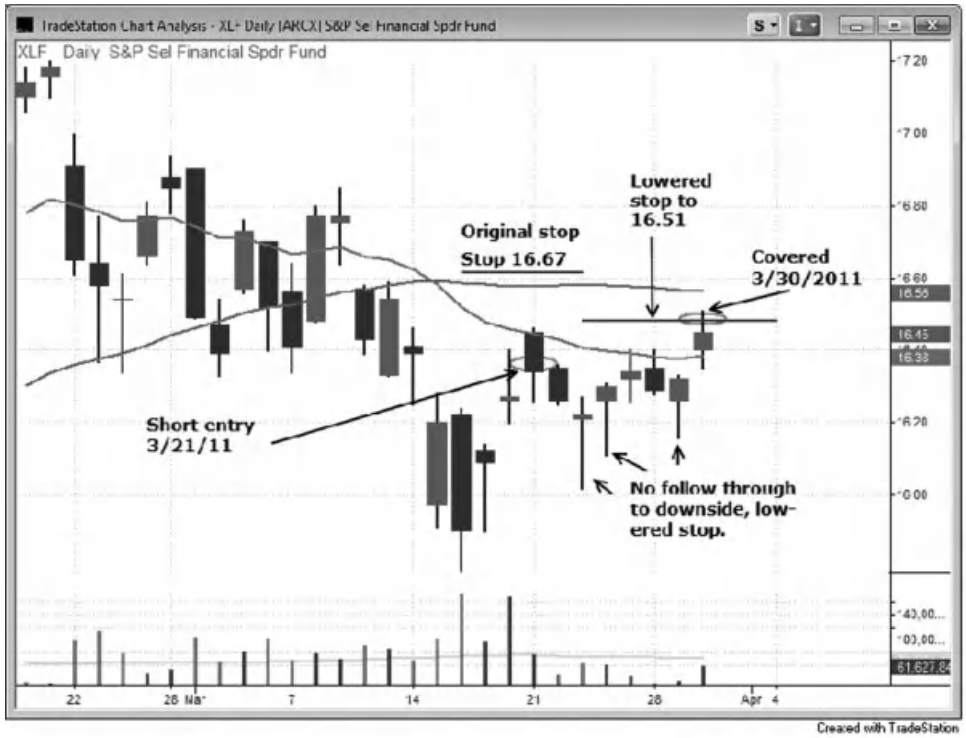
The day after we entered XLF, it moved in our favor but failed to break the March 21 low. On March 23, XLF formed a massive reversal candle, despite the fact

**TABLE 7.14** Actual Trade Results—SPDRs Select Sector Financial (XLF)

| | |
|---|---|
| Entry | Sold short: March 21, 2011, at $16.31 |
| Exit | Cover: March 30, 2011, at $16.51 |
| Net gain/loss | −0.20 points (loss) |

*Source: The Wagner Daily*

**FIGURE 7.36** Exit out of XLF short




that it lost support of the two-day low. This was a warning sign that XLF might have had more strength than we suspected. Consequently, we lowered our stop to just above the March 21 entry date. Over the next four sessions, XLF formed two more reversal candles, eventually gapped up on March 30, 2011, and hit our stop. Due to our lowered stop, we sustained just a small loss.

XLF continued its move higher for another week before meeting resistance at the 50-day MA. We missed an excellent opportunity to reenter this trade when it overcut the 50-day MA on April 7, 2011. The chart in Figure 7.37 shows the short entry that eventually developed.

**FIGURE 7.37** Short reentry opportunity


## Example 15: Trend Reversal Short Entry—Unsuccessful Trade

On May 24, 2011, "we entered a new short position in the iShares Russell Microcap ETF (IWC) via an intraday alert. We liked the trade as a minor diversification from our position in IWM since IWC was showing signs of being the slightly weaker of the two. The 20-day EMA has clearly crossed below the 50-day MA on the daily chart of IWC, while the same cannot yet be said for IWM."

We labeled this as a higher risk trade since IWC was fairly extended to the downside, and an undercut of the four-day low ($50.27) could result in a reversal. However, the market was struggling at that time, so we placed a tight stop and entered the trade. Further, IWC had just formed two lower highs and a lower low. Trade details are shown in Table 7.15. Figure 7.38 shows the setup at time of entry. Figure 7.39 shows our exit point.

IWC—Short
Trigger = $50.18
Stop = $50.93
Target = $48.45

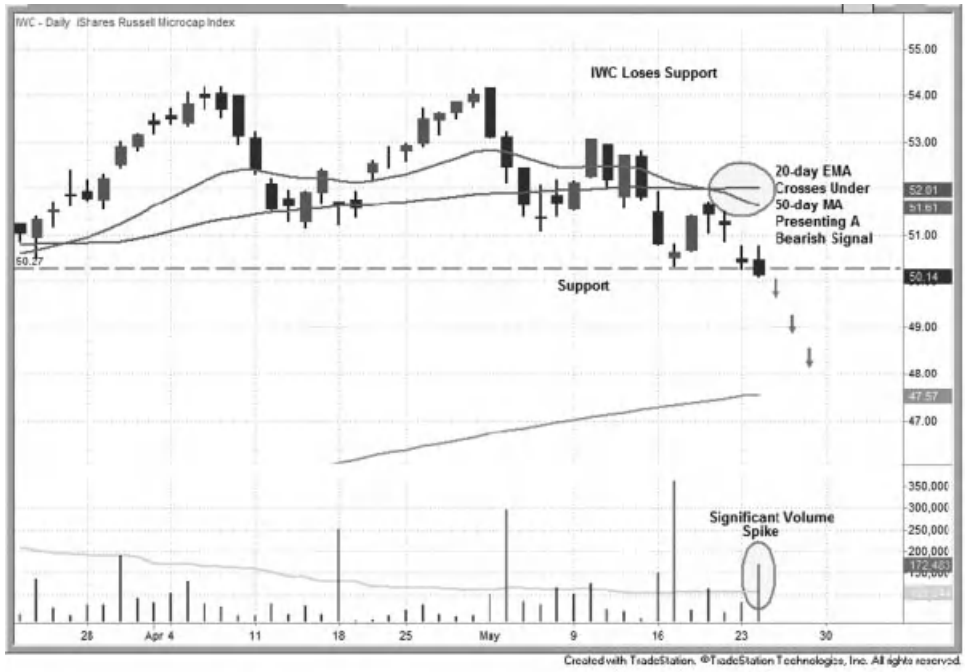
It's a good thing that we set a tight stop in this trade because the next day it was hit. In the blink of an eye, we were out of the trade. IWC then ripped higher for three

**TABLE 7.15** Actual Trade Results—iShares Russell Microcap Index (IWC)

| | |
|---|---|
| Entry | Sold short: May 24, 2011, at $50.18 |
| Exit | Cover: May 25, 2011, at $50.95 |
| Net gain/loss | −0.77 points (loss) |

*Source: The Wagner Daily*

**FIGURE 7.38** Short setup in IWC




more days before it crashed back down to earth on June 6, 2011. Overall, we don't have any criticisms about this trade because we had evaluated the risks appropriately before entering. On the short side of the market, if a trade doesn't move in your favor quickly, you are usually better off not being in the trade.

## What about "Short ETFs"?

By now, you're probably familiar with inversely correlated "short ETFs." These are ETFs that move in the opposite direction of the price of their underlying securities or index. Therefore, one is essentially taking a short position when buying one of these short ETFs. However, as detailed in the second edition of our last book, *Trading ETFs: Gaining an Edge with Technical Analysis*, these ETFs are not designed to be

**FIGURE 7.39** Exit out of IWC short trade


held more than a few days at most because they will generally underperform due to the daily rebalancing of their portfolios. Therefore, we rarely trade in short ETFs, and instead prefer to sell short the actual ETF. Nevertheless, some of our subscribers still prefer to buy the short ETFs instead, especially if they have a nonmarginable trading account, such as an IRA.

Now that you have had the opportunity to evaluate 15 actual long and 15 actual short trades from our newsletter, *The Wagner Daily*, we shall delve into a very fascinating and important topic . . . the psychology of trading. At various times during this section of the book, we have touched upon some of the key points regarding trading psychology, but this topic deserves much greater analysis. So what does it take to master the psychology of trading? We shall see in the next chapter.

*Advanced Technical Analysis of Etfs: Strategies and Market Psychology for Serious Traders*
by Deron Wagner, Edward Balog


# PART IV

# Mastering the Psychology of Trading

# CHAPTER 8

# Road Map of Market Psychology

Why is it that you can take any two traders, put them side by side, and give them the identical trading plan with detailed instructions, and yet the trading results they attain end up remarkably different? Why does one trader consistently lose money and another consistently make money with the same trading plan? Although there are many factors that might account for this, it is our belief that at the core of success and failure in trading is individual psychology. In our opinion understanding individual and group psychology is the most important aspect of becoming a successful trader.

We can teach anyone our swing trading methodology. We do it every day. But from working with thousands of traders over the years, we've come to the conclusion that a thorough understanding of both market (group) and individual psychology is what separates the best traders from the rest of the pack. It's what's referred to as the "alpha" factor in the trading world. Specifically, alpha is the ability of one trader to realize a greater rate of return than could be otherwise explained by the trading model itself. It's what keeps good traders from overtrading, consistently following the system, and knowing when to be on the sidelines. It also involves the ability to stop out of trades and not get shaken out of good trades. The ability to do these things is easier said than done.

Some might argue that developing a trading plan and keeping a trading journal (trade statistics) is the cornerstone to trading success. Although these practices are very important, we would argue that individual psychology is what drives the desire and willingness to create and develop each of the above. Understanding your own psychological strengths, weakness, comfort zone (the trading style that best fits your own unique trading style preference . . . your comfort zone), and the influence the group has on you as an individual may very well be the key to what separates you from those who are unsuccessful traders.

In addition to trade management, the psychology of trading is probably the most difficult to master. The reason is due to the fact that there is no substitute for experience, and there is very little written about the psychology of trading. Further, many traders tend to be more mathematically oriented and less interested in such soft

subjects as psychology. However, to ignore the psychology of trading is to almost ensure failure as a trader. Most traders only turn for help with this topic when they have blown up their account and have hit rock bottom.

Many trading sites recommend that new traders paper trade to gain experience by practicing in a simulated account. This may be good for learning to spot technical patterns and entry points; however, it's impossible to simulate the psychological side of a trade unless you are actually putting your own hard-earned money at risk. In order to master the psychology of trading, a trader must work her way through hundreds of trades to identify her psychological strengths and weaknesses.

With all of this in mind, our goal for this chapter is to provide a logic-based interpretation of market activity in order to improve your trading psychology. If you are able to interpret the subtle signs the market provides when market corrections are nearing, your trading will improve and so will your psychological state. We also want to leave you with a better understanding of how individuals interact to form a group, and how the group drives market cycles.

## The Individual versus the "Group"

Quite often we will hear traders comment that "the market is acting irrationally" or "Who in their right mind would buy/sell this EFT at these prices?" These comments are quite revealing. Essentially what these individuals are saying is, "I'm correct. I know the reasons that this ETF should be rallying or selling off, and my reasons are logical and rational. The market is being illogical and irrational." What's interesting about this entire line of thinking is that the trader is presuming that markets (the group) should behave in a logical and rational manner, as defined by the trader. Conversely, it also presumes that at the moment a trade is going against the trader, the market is acting irrationally. Both presumptions could not be farther from reality. We have a saying at Morpheus Trading Group, "Markets are neither rational nor irrational, they just are." What is irrational, however, is for a trader to label the market as rational or irrational, and then fight against it.

## The Importance of Understanding Market Structure and Trader Psychology

Market structure refers to the forces behind the movements in the market (and how the group and the individual interact to create market movements). Understanding market structure is important to trading psychology because it provides a logical framework for understanding what often appears to be random or irrational behavior in the market.

As participants in the market, we are constantly interpreting events and information in order to make successful trade decisions. At first glance, many things appear to be irrational or defy logic. However, what may seem illogical at first is

actually logical, but it lacks an obvious explanation. As human beings, we seek order and logic from our environment. When explanations for events are easy to derive or require little or no explanation, it is easy to see the logic behind them, and we don't argue with the results.

For instance, if I place a stack of one hundred dollar bills in a fire, then it will burn to ashes. The explanation for why the money is now ashes is simple: I stuck it the fire. Now, let's analyze this behavior in terms of the stock market. Placing your money in the fire is like making an "investment" in information and the ashes that you receive are the payoff (in this case negative). In the case of this investment, once you observe that placing your hard-earned cash in the fire results in the complete loss of your capital, you'll never do it again (unless you're crazy or very cold).

However, in the real world of trading, explanations are rarely this simple. When explanations are not obvious or if the explanation you come up with is wrong, there is a tendency to describe the results as illogical or irrational. Let's use the sport of golf as an example.

Golf has been described as a game of opposites. For instance, in golf, you must swing down to make the ball go up. When viewed on TV, it appears as if a golfer is swinging to "scoop" the ball in the air. It also appears that players are lifting the club into the air and over their head at the end of the swing. However, in reality, a golf ball becomes airborne because the club head is "square" to the ball at impact, and the ball is pinched into the turf to create backspin. In golf, you hit down to make the ball go up. The club face never scoops under the ball! Further, at the completion of the swing, the club is never lifted skyward. Rather, it is the rotation of the hips through the swing and the follow-through of the arms in a pendulum-like fashion that bring the club over the opposite shoulder. In fact, golf pros often have students release the club at impact with the ball to demonstrate that the club is never lifted skyward. Once the club hits the ball, it no longer serves a purpose. The golf shot occurs at the moment of impact of the club face with the ball. However, to casual observers, none of this is apparent, and it certainly defies what they believe they are seeing.

During the height of the bull market in 2000, an incredible number of stocks were trading at P/E ratios well in excess of 100 to 1. At one point during the frenzy, Qualcomm was trading with a market cap close to that of IBM. Based on a strict definition of irrational, this type of price action would certainly fit the criteria. However, despite the apparent irrationality, QCOM was nonetheless fetching $1,000 per share, and there were still hundreds of stocks trading at multiples in excess of 100 to 1.

The problem with this type of thinking is that the group (market) has its own definition of what is rational and irrational. The market (group) defines rational as whatever price the ETF is trading at and whichever direction the market is trending. Ultimately, what is irrational is to think of the market in terms of being rational or irrational. It's even more irrational to argue with the market by trading against current price action. It is also irrational to not change your opinion when you are consistently losing money, or to bail out of winning trades when the setup clearly suggests that you should remain with the trade. It's irrational to trade with too much size and to not honor stop losses.

## Understanding Market Structure Is Critical to Trading Psychology

Trends take a long time to develop, but once they are in place they are not easily changed. Trends last so long and resist change because they are controlled by the group and not any one individual. Further, the group is composed of subgroups that enter and exit the market at varying degrees and times. Market structure and trading psychology are inextricably linked because when traders don't understand market structure, they are more likely to trade against the prevailing trend and fight against the group. This occurs because, psychologically, individuals seek rational explanations for market behavior. In the absence of a rational explanation, traders will generally impose their own explanation, which generally involves labeling the market as "irrational." But if a logical explanation for market behavior is available, there is no reason to fight the market and damage your own psychological state. With logical explanations comes understanding, and with understanding comes psychological closure. In the absence of a logical explanation, traders fill the gap with their own perception of what they believe reality should be, and that behavior can result in a lot of losing trades. Losing trades lead to self-doubt and a sense of desperation. Ignore market structure at your own peril.

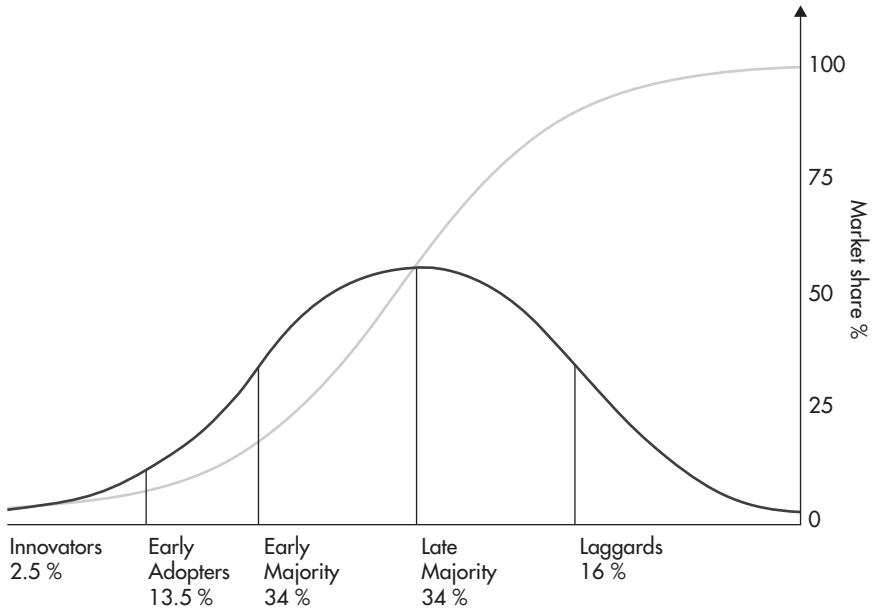
Another pitfall that occurs when market structure is not understood is that you can be correct about a trade idea but still lose money because your timing was off. Understanding market structure helps improve your ability to reasonably time market turns. As that old Wall Street adage goes, "the market can remain irrational longer than you can remain solvent."

Trends occur and are persistent not because individuals jump on the bandwagon all at once; rather, they occur because large groups of individuals enter and reenter the group at varying times. This is why the market moves in up-and-down, wavelike patterns. Interestingly, the group becomes the largest and most strongly imposes its will on the market in the final phase of a major trend (up or down). This is the moment that terms such as "irrational exuberance" begin to enter the lexicon. Another potential sign is when complete neophytes begin giving advice on the market (everyone's an expert). It is claimed that in 1929 Joe Kennedy decided it was time to get out of the market after a shoeshine boy gave him stock tips.

When unrelenting optimism or pessimism dominates the conversation around the water cooler, and positive or negative news dominates the media landscape, a turn in the market may soon be at hand. Reversals occur when no one expects them. Why? Because reversal signs are subtle, the moves are quick, and the group is completely committed to the prevailing trend. When complete optimism or pessimism dominates the market, a trader must quickly revert to the role of an individual and divorce him- or herself from the group. Psychologically, this is very difficult to do. During extremes in the market, it's also difficult to adopt an individualist mentality because, at that moment, the group is exerting the most dominance in the market.

As an analogy, think of trends in the market in terms of the product diffusion curve in marketing. Not everyone buys a new product or innovation at the same

**FIGURE 8.1** Innovators → early adopters → early majority → late majority → laggards




*Source*: Everett Rogers, *Diffusion of Innovations*, 1962

time. Rather, technology transfer and new product adoption are embraced by varying groups of individuals at varying times throughout the product life cycle. Research has shown that a new product is purchased (adopted) by subgroups in the following wavelike manner. The cycle looks like this: innovators → early adopters → early majority → late majority → laggards. Figure 8.1 provides a more detailed representation of this concept.

The only difference between the product diffusion curve and bull market cycles is that the prices paid by individuals are higher at the beginning of the product life cycle and lower at the end of the cycle. But this is just the opposite for stock prices. In stock market terms, innovators and early adopters pay the lowest prices for stocks while the early majority and late majority buyers pay the highest prices for stocks.

Specifically, in the product life cycle, the highest prices are paid at the beginning of the cycle and the lowest are paid at the end of the cycle. However, with stocks, the price is the highest at the end of an uptrend and lowest at the end of a downtrend.

Remember, most consumers are NOT innovators or early adopters of new products. Rather, they are early majority and late majority buyers. The same holds true for the stock market. In the stock market, most traders miss the "meat of the move" and are therefore more prone to be swayed by greed, fear, hope, and regret. Think of it in this manner: If traders are buying near the top of a trend or short selling near the bottom of a trend, small movements in price against their position will elicit a big response by these investors. They are more inclined to sell their long

position and cover their short positions quickly. So, by the end of a trend (up or down), it only takes the slightest movement in price to elicit panic among those who entered the market late. In an uptrend this would include a portion of the early majority buyers and almost all of the late majority buyers. This also holds true for laggards, but at varying degrees. As for the initial early majority buyers, they have a bit more staying power. Buyers who get in at the innovator or early adopter stages have little fear in the early stages of a reversal because they are well "in the money." In fact, these buyers are more inclined to buy on pullbacks, thereby causing the market to bounce.

The closer the trade is made near an extreme in the market (top or bottom), the smaller the price move required to elicit a response by late market entrants. Late buyers in an uptrend are most likely to panic first. The same holds true for late sellers in a downtrend. The worse the entry price, either on the long or short side of the market, the smaller the price movement necessary to invoke panic.

Another way of approaching this concept is to think of the larger group as being composed of smaller subgroups of individuals, each of which have different propensities to enter/exit the market at different times. We believe that the propensity of individuals to enter/exit the stock market is directly related to Fibonacci theory and the varying willingness and ability of the individuals that compose each subgroup to tolerate/embrace or reach their breaking point with respect to the emotions of fear, greed, hope, and regret. In economic terms it might be described as the marginal propensity to remain in a position when faced with the emotions of greed, fear, hope, and regret. Individuals have varying degrees of ability and willingness to withstand losses or remain in winning trades. We believe this is what creates the wavelike patterns in the market.

As traders we are constantly in a battle between the need to think and act independently and yet avoid the urge to fight market momentum. In the United States, individualism is engrained in our psyche. We are socialized from a very young age to hold dear such beliefs as rugged individualism, constitutional rights of the individual, independent thinking, the protection of individual rights, and embracing the maverick nature of entrepreneurship.

A trading idea can be correct, yet end up losing money because the trader (individual) believes so strongly in the trade that he fights the market's momentum (the group). This often occurs because a trader has the correct idea but the wrong market timing. Markets shift momentum when the group decides to shift the momentum and not when the individual trader believes or hopes the trend shift should occur. As a trader, the trend is your friend, and fighting it will only result in losses, a battered psyche, and an empty wallet.

## Greed, Fear, and Hope . . . What About Regret?

Most books written on trading psychology discuss the emotions of fear, greed, and hope and the role they play in market psychology. However, our experience has

taught us that there are actually four psychological states or emotions that drive most individual decision making in the market. They are *fear, greed, hope*, and *regret*. Since the market is made up of individual human beings that tend to act in similar manners, a group is formed. It's the group's opinion that matters during a trend, but it's the individual trader's job to identify the subtle clues as to when a market is about to shift direction. The clues are there, but they are subtle, and even if the individual is aware of these warning signs they are often ignored or mitigated.

An awareness and detailed understanding of these emotions is what keeps the trader out of trouble by providing a means to identify individual weaknesses. We shall now take a closer look at these emotions and provide examples of how they influence a trader's ability to consistently make money.

## Greed Defined

Greed is commonly defined as an excessive desire for money and wealth. In trading terminology it can also be defined as the desire for a trade to provide an immediate and unrealistic amount of profit. When greed sets in, all traders can focus on is how much money they have made and how much more they will make by staying in the trade. However, there is a major fallacy with this type of reasoning: A profit is not realized until a position is closed. Until then the trader only has a POTENTIAL profit (aka paper profit). Greed also often leads to ignoring risk and sound risk management practices.

## Fear Defined

Fear is defined as a distressing emotion that is caused by a feeling of impending danger, which results in a survival response. This holds true regardless if the threat is real or imagined.

Fear is probably the most powerful of all human emotions. When traders become afraid, they will sell a position regardless of the price. Fear leads to panic and panic leads to poor decision making. Fear is a survival response. People have been known to jump off buildings during market panics. By contrast, no one has ever jumped off a building because of greed. It took the Dow Jones Industrial Average from 1983 until 2007 (24 years) to rally from 1,000 to 14,200, but it only took two years to lose half of its value (2007−2009). That's a dramatic example of the power of fear.

Fear is a good emotion if it gets you out of a bad trade. If a stock hits its stop and the trader exits the trade, then the fear of losing an excessive amount of money protects the trader from financial ruin. However, fear can work against traders when they don't enter a quality setup because they have had a series of losing trades. Just because traders have lost money in the previous trades doesn't mean they should be fearful of entering the next trade. That's why we have trading plans. Trading systems are intended to take the emotions out of trading. If you're afraid to enter a quality setup, then there's no point in even trading.

When the market is in a state of panic or fear, traders should never try to rationalize or come up with excuses for why they shouldn't get out of their positions. During times of fear and panic, it is best to go to cash. Listening to the news, the government, stock experts, or other traders' opinions is a waste of time. If the market (the group) is in a state of panic, it is best to not fight the trend. The group will always win. You don't have enough money to hold the market up. It's pretty simple . . . when institutional traders decide to dump their positions, the market will fall. When there is fear, steer clear! When in doubt, get out!

### Hope Defined

Hope is a feeling of expectation and desire for a certain thing to happen. It's an individual's desire to want or wish for a desired event to happen.

Hope may be the most dangerous of all human emotions when it comes to trading. Hope is what keeps a trader in a losing trade after it has the stop. Greed and hope are what often prevent a trader from taking profits on a winning trade. When a stock is going up, traders will often remain in the trade in the hope of recouping past losses. Every trader hopes that a losing trade will somehow become a winning trade, but stock markets are not a charity. This type of thinking is dangerous because the group (stock market) could care less about what you hope for or what is in your best interest. Rest assured, when your thinking slips into hope mode, the market will punish you by taking your money.

### Regret Defined

Regret is a feeling of sadness or disappointment over something that has happened or been done, especially when it involves a loss or a missed opportunity.

The negative implications of this emotion are obvious. It is only natural for a trader to regret taking on a losing trade or missing a winning trade. What is important as a trader is not to hyperfocus on losing trades or missed opportunities. If you lose money on a trade, then you evaluate what went wrong and move forward.

Other than the lessons that can be gained from evaluating each trade, there is no point to spend further time regretting the decision to enter the trade. It is also human nature to feel regret when an opportunity is missed. If you miss a winning trade, then you must move on to the next potential trading opportunity. When traders allow regret to rule their thinking, they tend to "chase trades" in the hopes of still being able to make money on the position by entering it well above the trigger price or when it is severely extended.

The problem with this thinking is that the risk/reward of the trade no longer meets the parameters of good trade management. For instance, by entering a trade 1 point higher than the trigger, the potential reward may be 1 point, but the potential loss may also be 1 point. This sets the risk/reward ratio at 1 to 1. However, if the trade had been entered at the appropriate trigger price, the risk reward ratio would have been 2 to 1. Good traders learn to discipline their mind to eliminate regretful thinking.

**FIGURE 8.2** Emotions that drive the market


Psychology and emotions are a big part of trading. All good traders focus on identifying their own personal psychological weaknesses and finding ways to make sure these emotions don't negatively affect their trading. Remember that the group determines whether or not a particular stock moves higher or lower. Your personal greed, fear, hope, or regret will not change the market's opinion. When you are wrong about a trade, admit it and move on. When you are correct about a trade, take your profits when the target is hit. It's okay to constructively analyze why a trade was unsuccessful, but it's not okay to hyperfocus on a losing trade. If you don't take the time to understand the psychology of trading, the market will gladly take your money.

Figure 8.2 is an amusing diagram that does a very good job of summarizing all of the emotions that drive the stock market.

With your new-found knowledge of the four stages of a market cycle and the psychology that drives both group and individual behavior, we are hopeful that this information will enhance your trading profitability. Never underestimate the power of a trend or the impact that your own psychological state can have on your trading.

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# CHAPTER 9

# Understanding the Four Stages of Every Market Cycle

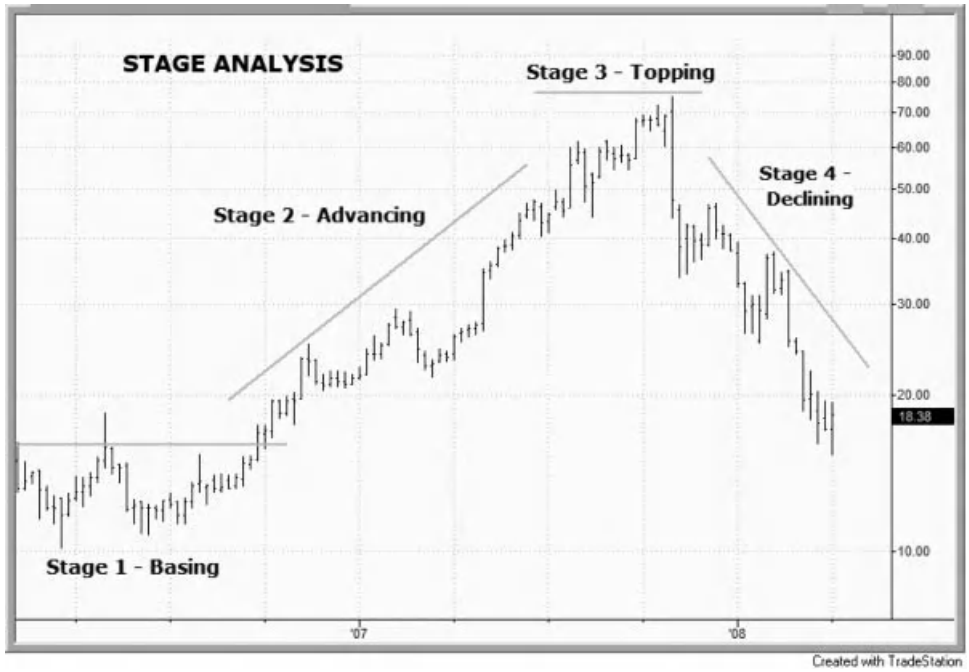
Understanding the four stages of every market cycle is critical to trading since it's the only thing that keeps you in the direction of the trend. If you are unaware of what stage the market is likely in, you will end up fighting the market (group) at your own expense. Further, understanding the market stages is understanding market timing. Each stage provides subtle signs as to its identity.

If you are not aware of these signs or don't know what to look for, it is much more likely that you will be trading on the wrong side of the trend or overtrading, and the four powerful psychological emotions we discussed will wreak havoc on your results. Since poor trading is often a result of the lack of understanding of market structure, you suffer psychologically as a trader, which further compounds the likelihood of trading losses. Figure 9.1 provides a visual of each stage of any market cycle.

## Stage 1: Accumulation or Basing Action

During the first stage of a market cycle (uptrend), price action begins to consolidate or tighten. You will notice many accumulation days occur in a tight range. An accumulation day occurs when the broad market closes at least .3 percent higher on higher volume than the previous day. Accumulation days are a sign of institutional buying, and institutions move markets, not individuals. We look for at least a seven-week base in which there are at least four accumulation days (gains on higher volume). Further, at the end of the seven-week base (the right-hand side of the base), you don't want to see many, if any distribution days (higher volume selling). Basically, you don't want to see distribution during the last two weeks when a base is forming. It's very difficult for a market to break out in the presence of recent distribution days.

**FIGURE 9.1** The four stages of every market cycle




## Stage 2: Breakout/Trending Phase

During a breakout or trending phase, strong ETFs move above all major moving averages, including the 20-day EMA, 50-day MA, and the 200-day MA. Stage 2 in the cycle is characterized by a big volume breakout from the consolidation base formed in stage 1. In addition, pullbacks generally last for four to 10 days and occur on light volume in a tight range. Major selloffs do not occur in the trending phase. Selling is controlled and only lasts for a short time. Successive higher highs and higher lows are set during a trending phase and again, pullbacks are of short duration. During this phase, buyers overwhelm sellers, as evidenced by a vast majority of accumulation days and very few distribution days. Distribution days are defined as a lower close (down .3 percent or more) on higher volume. Pullbacks are usually 20 percent or less in the trending phase.

## Stage 3: Topping/Exhaustion

During the exhaustion or topping phase, price action begins to widen and the number of distribution days becomes more frequent. Generally, the long-term uptrend line of the ETF or market is broken. Sellers begin overtaking buyers as is evidenced by more distribution and volatility. Price swings are dramatically wider

than they were in the trending phase. Volume picks up significantly compared to the "meat" of the trending phase. This is the phase where you generally see the biggest spikes in volume. Combined with whippy price action, this is an early signal that the market may be running out of steam. This is the time that professional traders and institutions are selling into strength.

During the topping phase, you must pay close attention to the number of distribution days that occur. You do not want to see an accumulation of distribution days. *If there are more than five days of distribution during a 20-consecutive-day trading period, the likelihood of a market reversal increases dramatically.*

Other characteristics of the exhaustion phase are when the market or an ETF is unable to set new highs and often begins setting a sequence of lower highs. Further, the 200-day MA starts to flatten out. This phase occurs over several months and short opportunities may begin to enter the market. However, it can be difficult to trade during this phase because the price action becomes choppy (volatility increases).

Another characteristic during this time is that the 50-day MA begins to flatten out and price action oscillates widely around this moving average. Pullbacks also intensify in both abruptness and size. Instead of the market pulling back 20 percent during a correction off the 52-week highs, it begins pulling back 30−35 percent off the highs. You will also witness the 20-day EMA cross below the 50-day MA. Finally, at the end of stage 3 the 20-day EMA and 50-day MA crack below the 200-day MA, and prices fall below the 200-day MA.

### Stage 4: Trend Reversal/Declining Stage

This is the phase in which the trend reverses from an uptrend to a downtrend and vice versa. A trend reversal is established when the market sets a lower high followed by a lower low. Another requirement is that the former uptrend line is broken.

Price volatility increases even further than in stage 3 and volume expands on the downside. Declining volume overwhelms advancing volume and market leaders begin to drop below critical moving averages. The selloffs are dramatic. Often two or three months of price action can be wiped out in two weeks or less.

As discussed in our trade examples of short selling, declines are usually dramatic. It took from 1982 until 2007 for the DJIA to advance from 1,000 to 14,700, but it only took from late 2007 until the beginning of 2009 to drop 55 percent. During stage 4, massive price capitulation is the norm as investors bail out of the market. The drop in the market makes it look as if there's no bottom in sight. In addition, news coverage is blanketed by overwhelming negativity.

As you can see, understanding market structure plays a critical role in investor psychology. Without this understanding, you are flying blind as a trader. You don't see the subtle signs. Further, when you don't understand market structure, there is a tendency to label market behavior as irrational and fight with the "group" by taking on countertrend trades.

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# PART V

# Latest Developments in ETF Trading

CHAPTER 10

# Latest Trends and Innovations in Exchange-Traded Funds

Since its conception nearly 20 years ago, the exchange-traded fund (ETF) industry has been a center of change and innovation for the individual investor. There is a constant supply of new exchange-traded products being introduced virtually every month. In addition to innovative new products, there are also new trends that every ETF investor should be aware of. The purpose of this chapter is to put the latest innovations and trends at your fingertips.

## Can You Say Free, Anyone?

A recent trend in ETF investing doesn't involve ETFs directly at all. Did you know that you can now trade ETFs commission free? In an effort to compete more effectively with mutual funds, the ETF world has introduced both lower expense ratios and, in some instances, commission-free trading. New trading platforms are now available through brokerages such as E*Trade, TD Ameritrade, Interactive Brokers, Scottrade, and Charles Schwab. Other brokerages are likely soon to join this wave of commission-free trading. This list may not cover all of the brokerage houses that provide commission-free trading, so call your broker to see if this latest trend is available on your trading platform. The exchange-traded products that can be purchased and sold commission free is broker specific and certain restrictions may apply. Currently, there are about 200 ETFs available for commission-free trading. Dollars saved on commissions are dollars in your pocket. Again, we suggest that you contact your brokerage firm for further details on this exciting new development in exchange-traded products.

## Innovative Investment Discipline ETFs

The Russell family of ETFs has recently added what are known as investment discipline ETFs. Per Russell's website, "Investment Discipline ETFs provide investment vehicles designed to give investors exposure to investment approaches commonly used by professional investment managers. Russell Investment Discipline ETFs can be used in multiple ways to attempt to gain strategic market exposures to specific investment disciplines or implement a tactical position based on a market view."

The investment discipline strategies employed by the new line of Russell products include Aggressive Growth, Consistent Growth, Growth at a Reasonable Price (GARP), Equity/Income, Low P/E, and Contrarian. Following is an explanation of two of these products.

The Growth at a Reasonable Price or GARP strategy looks to invest in companies with high prospects for growth that are trading at moderate valuations. GARP funds invest in quality companies with above-average ROE and below-average volatility of earnings.

The Russell Contrarian strategy focuses on companies that are currently "out of favor" in investment circles. They focus on stocks that are severe underperformers to the market and/or the sector. Potential investment candidates include companies with poor earnings and revenues that may be a result of a short-term issue that may soon stabilize. Contrarian investment funds have long investment horizons since they invest in companies that are at extremely low valuations.

The basic concept behind all of these products is to provide the average investor with access to unique and advanced strategies that, heretofore, were only available to a limited circle of investors. Further, they offer investment strategies and objectives that would be virtually impossible for the average investor to replicate or achieve. These investment products are passively managed and are driven by a rules-based approach in the hopes of improving performance and not just tracking the market.

## BDC ETNs

Business development companies (BDCs) are venture capital–like companies that help small companies realize growth in the early phases of their development. Many BDCs are publicly traded companies and therefore have become the focus of the ETF industry. Recently, UBS launched E-TRACS, which is a BDC linked to the Wells Fargo Business Development Company Index (BDCS).

## International Small-Cap ETFs

Investors are always looking for superior returns, and what better way to accomplish that than with small-cap international ETFs. Small-cap international ETFs provide the investor with access to a variety of international companies beyond the large-cap

funds, which are weighted highly with international banks and utilities. Therefore, large-cap international funds don't provide the investor with high-growth opportunity sectors such as health care and biotechnology. Small-cap ETFs now include funds for Canada (CNDA), China (YAO), India (SCIF, SCIN), Germany (GERJ), Russia (RSXJ), Mexico (MEXS), and South Korea (SKOR), to name a few.

## Contango-Proof Your Commodity Exposure

An inherent performance issue that is problematic for a buy-and-hold commodity ETF strategy is directly a result of something known in futures trading as *contango*. Contango is a condition that exists in the futures markets when the cost to buy the next month's contract (forward month) is greater than the value of the current month's contract or, more specifically, the current month's contract price as it approaches expiration. As the current contract approaches expiration, it gets closer and closer in value to the spot price of the commodity until they approximate each other at expiration. However, when contango is present in the market the cost of the forward month contract is higher than the current month's contract at expiration. The contango problem is also a function of the disproportionate number of contracts that an ETF holds as a percentage of the outstanding interest in all contracts for a given commodity.

When the commodities markets were much smaller than they are today, most commodities traded in a state of *backwardation*. Backwardation is the opposite of contango. Backwardation exists when the current month's contract trades at a discount to the forward month's contract. When a market is in backwardation it favors the commodity ETF investor. However, for reasons beyond the scope of this book, it is now more common for commodity ETFs to trade in a state of contango rather than backwardation, thus making long-term investing in commodity ETFs a dangerous proposition.

The contango problem arises each month when the futures contracts for the underlying commodity are set to expire because the fund manager must "roll over" the existing contracts. *Rollover* refers to the process of selling the expiring contracts and simultaneously buying the next month's contract. This is a mechanical trade that must be executed by the fund manager in order for the commodity ETF to limit the potential loss exposure in the futures market. It is also mechanical because it is mandated per the prospectus of most commodity ETF funds. Remember, when trading futures it is possible to lose more than the initial money invested due to the extreme leverage involved. Further, and with rare exceptions, it is not practical or possible for an ETF to take delivery of the actual commodity.

This leads to another problem know as *front running*. Front running is a trading practice in which futures speculators and hedge funds actually fuel contango by shorting the current month's contract that is set to expire while simultaneously going long the next month's contract, thereby driving the price of the current month's contract lower and the forward month's contract price higher. Front running can also

lead to contango when hedge funds take physical delivery of the commodity. For instance, many hedge funds lease oil tankers and take delivery of the physical commodity in order to hold prices up and thereby force the oil commodity ETFs to purchase the next month's contract at a much higher price, thereby creating contango. Since speculators know when the contracts are set to expire (the expiration dates are set each month), this generally exposes the commodity ETF to a guaranteed loss.

Therefore, if a fund can't easily take physical delivery as is the case with gas or oil, then contango presents a constant problem. Why? In most cases it is not practical or not permitted per the prospectus for an ETF to take delivery of the physical asset. Therefore, the fund manager must roll the expiring contract over immediately and pay the temporarily higher price. Again, this results in a guaranteed loss for the fund.

To combat the issues inherent to commodities in contango, new contango-resistant products have been developed. One commodity ETF that claims it has solved the contango issue is the United States Copper Index Fund (CPER). CPER claims that their unique structure allows them to buy the lowest cost futures contracts each month over an 18-month cycle rather than having to purchase the next month's contract, which can result in contango.

Another fund designed to fight the effects of contango is the United States Commodity Index Fund (USCI). This fund has been referred to in the ETF industry as the "contango killer." USCI employs strategies similar to that of CPER to fight the undermining effects of contango.

## Emerging Market Sector-Specific ETFs

Another recent innovation in the ETF world is the emergence of sector-specific funds. Heretofore, investors seeking exposure to emerging markets could only accomplish this through index-based ETFs providing only broad exposure to a specific country. However, in 2011 EGShares introduced a sector-specific emerging market family of ETFs designed to give the investor exposure to a broad array of investment strategies. These sector-specific products now allow money managers and individual investors to rotate funds to the strongest performing international sectors, thereby enhancing returns. International sector-specific products introduced by EGShares (known as the "GEMS" family of funds) include industrials GEMS (IGEM), consumer goods GEMS (GGEM), basic materials GEMS (LGEM), consumer services GEMS (VGEM), financials GEMS (FGEM), technology GEMS (QGEM), health care GEMS (HGEM), energy GEMS (OGEM), and utilities GEMS (UGEM).

## Volatility Exposure ETFs

Volatility exposure ETFs are funds that provide access to the VIX (Volatility Index Futures) as a means to hedge against downside volatility. VIX-based strategy ETFs

are negatively correlated to the stock market and therefore offer protection in the form of a hedge during bear markets.

- **ProShares** offers four VIX ETFs including VIXY, VIXM, SVXY, and UVXY.
- **VIX exposure in the form of VIX ETPs:** One popular product that offers short exposure through index futures is the VelocityShares Daily Inverse VI (XIV).
- **VIX Exposure via Leveraged ETFs:** For those less faint of heart, leveraged VIX ETPs are now available. TIVX is one ETF that offers leverage on top of leverage.
- **Long/Short Strategy VIX ETFs** such as UBS's Daily Long-Short VIX ETN (XVIX) provides a mixed exposure asset consisting of a 100 percent long position in the S&P 500 VIX Mid-Term Futures Index Excess Return, combined with a 50 percent short exposure in the S&P 500 VIX Short-Term Futures Index Excess Return.
- **Targeted VIX ETFs** are offered by UBS. These funds focus on varying maturities of one to six months.

These products are highly leveraged and must be used with caution. Nonetheless, VIX products can be quite useful during times of bear market volatility.

The ETF industry is in a constant state of innovation. For 2012 it is estimated that over 200 new ETFs will be introduced to the marketplace. The industry's goal is to provide newer and better ways to give individual and professional investors access to investment strategies and markets that were at one time not available.

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# CHAPTER 11

# Important Accounting Considerations

The biggest component to being a successful and profitable trader is obviously having a proven trading strategy and the discipline to stick to it. However, there are often overlooked considerations that can impact your bottom line. With certain classes of ETPs, there are key accounting considerations to be aware of. Ironically, these considerations are not well known, so we're dedicating a chapter of the book to bring you up to speed.

Before we get into more detail with respect to asset classes and legal structures, it is important to cover a few important tax definitions.

*Long-Term Capital Gains*—Taxable gains that are realized from the sale of an asset that is held for greater than one year (at least one year and one day).
*Short-Term Gains*—Taxable gains that are realized from the sale of an asset that is held for one year or less.

The tax treatment of exchange-traded funds (ETFs) and exchange-traded notes (ETNs) can be very difficult to research and is quite confusing for the average investor. However, it is a very important subject for investors to understand. Let's face it, for most investors (most people, for that matter) the tax code is cumbersome, confusing, and boring. Yet, without adequate knowledge of the tax treatment of both ETFs and ETNs, an investor runs the risk of incurring major unforeseen tax liability, which can significantly affect portfolio performance. So, let's demystify much of the confusion associated with this daunting topic.

## Overview: The Difference between ETFs and ETNs from a Tax Perspective

The tax efficiency of ETFs is derived from the fact that the vast majority of ETFs are index funds and therefore experience low turnover (compared to mutual funds). Further, ETFs are structured with what is known as a "creation/redemption" feature,

which allows these funds to continually arbitrage away embedded capital gains. To avoid complicated explanations that are beyond the scope of this book, suffice it to say that ETFs hold a tax advantage over traditional mutual funds in large part due to their "creation/redemption" structure.

ETNs are considered more tax-friendly than traditional ETFs in most instances. The reason is due to how distributions are handled. ETFs, like mutual funds, are required to distribute all interest and dividends they collect on their investments to shareholders annually. If the distributions are received by an investor on a *taxable account*, then they are subject to taxation on these distributions at ordinary income rates (up to the maximum marginal taxable rate of 35 percent). On the other hand, ETNs are not required to distribute income or dividends. Instead, ETNs adjust the fund's net asset value to incorporate the interest and dividends earned. Essentially, because they are structured as notes, ETNs don't make capital gains distributions. Consequently, the ETN investor does not pay taxes until the ETN is sold. Additionally, if the ETN is held for more than one year, then the distributions are taxed at the long-term capital gains rate of 15 percent.

There is one exception, however. Under an IRS ruling issued December 7, 2007, currency ETNs were stripped of their long-term capital gains tax advantage. Under the new ruling, all distributions are taxed as ordinary income at the maximum marginal tax rate of 35 percent. Under this ruling, investors are also required to pay taxes on interest income even if it is embedded (incorporated) into the note. This means that the investor must pay taxes on the interest income even though it is not distributed by the fund, and the income won't be realized until the fund is sold.

Unlike currency ETNs, commodity ETNs have another tax advantage over ETF products. With a commodity ETN, taxes are only paid when the fund is sold. This results in the investor receiving the much more favorable long-term capital gains rate if the fund is held for greater than one year. Most commodity ETFs invest in futures contracts and are set up as limited partnerships. Consequently, investors pay taxes on any capital gains realized by the ETF during the calendar year. In addition, ETFs that invest in and take physical possession of precious metals (i.e., gold, silver, platinum) are viewed as collectables by the IRS. Consequently, they are taxed at the maximum long-term capital gains rate of 28 percent, and not the 15 percent rate associated with other investments. Again, currency ETNs don't have the same advantage as other ETNs. All interest from these ETNs is taxed as ordinary income on an annual basis even if it is unrealized.

## Mechanics behind ETF Taxation

The best way to understand the potential tax consequences associated with ETFs and ETNs is to have a firm grasp of how the IRS views each of the various types of exchange-traded products. From a tax perspective, the IRS views each exchange-traded product based on two criteria: (1) the legal structure of the fund, and (2) the

type of asset the fund is trading (the asset class) and the financial instrument(s) the fund uses to track the underlying index or asset it is tracking.

In the world of exchange-traded products there are essentially five asset classes and five legal structures under which these assets are traded. The five asset classes are commodities, fixed income, stocks, currencies, and "other/alternative." The five legal structures include grantor trusts (GTs), limited partnerships (LPs), open-end funds (OEFs), exchange-traded notes (ETNs), and unit investment trusts (UITs).

In order to understand how the various exchange-traded products are taxed, we shall evaluate them in terms of the five asset classes and which of the five legal structures have been used to create ETPs within each of the asset classes. We'll begin with commodity funds.

## Commodity Exchange-Traded Funds

Commodity exchange-traded products have been structured as limited partnerships (LPs), grantor trusts (GTs), and ETNs. The structure of the commodity fund determines how it is taxed. We will now review each of these legal structures used for commodity ETFs and how the IRS views each of them for tax purposes.

### Limited Partnership Commodity Funds (LPs)

Some commodity funds are set up as "commodity pools" under limited partnerships and offer "limited partnership interests" rather than individual shares. LP funds don't hold the physical assets (commodities) that they track; rather, they trade futures and other derivative contracts to track the value of the commodity. The PowerShares DB Commodity Index Tracking Fund (DBC), the United States Natural Gas Fund (UNG), and the United States Oil Fund LP (USO) are three funds that utilize the LP legal structure. In the past there had been concern by investors that gaining investment exposure to commodities via the limited partnership structure could result in unrelated business taxable income (UBTI) on *tax-deferred* accounts.

Naturally, investors in tax-deferred accounts do not want these investments to fall subject to taxable income, as it defeats the purpose of qualified accounts (tax-deferred). Under the IRS tax code UBTI is realized when a publicly traded limited partnership engages in business activities to generate income. In other words, income is generated through an "active" business. A good example would be a pipeline company, such as Kinder Morgan (KMP). KMP is set up as a master limited partnership (MLP), and it "actively" engages in business operations to generate income. This, however, is quite different from the way that LP commodity ETFs generate income.

In the case of such funds as UNG, USO, and DBC, all income is generated passively by investing in commodities via futures contracts. These funds do not actively engage in the commodity business, they only invest in commodities. Consequently, the IRS views this as passive income, which does not fall under the UBTI

regulatory classification. As long as these funds do not engage in "active" business practices, the IRS has held that they are not subject to UBTI.

Futures-based funds are taxed as follows: 60 percent of gains in the fund are taxed at the long-term capital gains rate (15 percent) and 40 percent of the gains are taxed as "ordinary income" to the individual irrespective of how long the shares are held. In other words, 40 percent of the income is taxable as ordinary income whether or not it is held for a time period that would otherwise fall under long-term capital gains. This results in a *maximum* total blended rate of 23 percent.

Limited partnerships do not pay taxes on profits. Rather, all profits, losses, and tax liabilities are "passed through" to the partners. This is important since ETFs set up as limited partnerships are also classified as pass-through investments. Consequently, all gains are marked-to-market annually and they are passed through to investors. This can result in a taxable event to the investor since the cost basis adjusts at the end of each year. By extension, this means that the investor could end up paying taxes regardless if the shares of the ETF have been sold. Further, each partner receives IRS form K-1 for income tax purposes annually, which can drive up the cost of tax preparation.

### Grantor Trust Commodity Funds

In contrast to limited partnership commodity ETFs, grantor trust (GT) commodity ETFs actually hold the physical commodity in inventory. Since GT funds hold physical inventory, it is impractical for most commodities to be set up under this structure. However, precious metals don't face the same wastage or storage issues as, let's say, corn, oil, or natural gas. Consequently, this structure works well for easy-to-store commodities such as gold and silver. Two funds that have adopted this structure include the SPDR Gold Shares (GLD) and the iShares Silver Trust (SLV). Gold and silver are compact and therefore easy to store, and they do not suffer from the possibility of wastage, as might cotton or livestock.

Under IRS tax regulations a direct claim on gold and silver (the physical asset) is considered a collectable for tax purposes. Owning gold and silver is considered the same as owning coins or any other collectable, and they are taxed differently than other types of investments. Collectables do not benefit from long-term capital gains tax treatment. Instead, all long-term gains are taxed at a maximum rate of 28 percent, and all short-term gains (one year or less holding period) are taxed at a maximum rate of 35 percent (as ordinary income).

### Commodity Exchange-Traded Notes

Commodity exchange-traded notes (ETNs) neither hold physical assets nor invest in derivatives contracts as a means of creating a return on capital. Rather, ETNs are senior, unsecured, unsubordinated debt instruments that are issued by an underwriting bank. As with any note, they are a promise to pay a specific return based on an index. Therefore, in addition to carrying market risk, they also carry credit risk of

**TABLE 11.1** Commodity ETFs—Tax Rates by Structure

| Fund Structure | Max. Long-Term Tax Rate | Max. Short-Term Tax Rate |
|---|---|---|
| LP | 23% blended rate 60% of gains taxed at LT capital gains rate and 40% of gains taxed as ST gains (ordinary income based on taxpayer's tax bracket) | 23% blended rate 60% of gains taxed at LT capital gains rate and 40% of gains taxed as ST gains (ordinary income based on taxpayer's tax bracket) |
| Grantor Trust | 28% | 35% |
| ETN | 15% | 35% |

the issuing bank. If the issuer becomes insolvent, is downgraded by a major rating agency, or goes bankrupt, then investors could potentially lose all of their invested capital.

Several well-known commodity ETNs include the iPath S&P GSCI Crude Oil Total Return Index ETN (OIL), the iPath DJ-AIG Coffee Total Return Sub Index ETN (JO), and the iPath DJ AIG Livestock Total Return Sub Index ETN (COW).

ETNs are debt instruments and don't hold any actual assets. Consequently, investors are taxed only upon the sale of the note. Taxes are incurred at ordinary income rates (maximum rate of 35 percent) for investments held one year or less, and at long-term capital gains rates for those held longer than one year (15 percent). See Table 11.1.

## Fixed-Income and Equity Funds

Fixed-income and equity ETFs are available under four different legal structures. They include grantor trusts (GTs), ETNs, open-end funds, and unit investment trusts or UITs.

From a tax perspective, both equity and income funds are the easiest to understand, since all ownership structures are treated identically. If the fund is held for greater than one year, then the long-term capital gains rate of 15 percent applies. However, if the shares are held for one year or less, the gains are treated as ordinary income, and are taxed at a *maximum* rate of 35 percent.

Table 11.2 summarizes the tax treatment for each ownership structure of equity and fixed-income funds.

## Currency Funds

There are four legal structures of currency exchange-traded products (ETPs). They include limited partnerships (LPs), grantor trusts (GTs), ETNs, and open-end funds.

**TABLE 11.2** Fixed-Income and Equity ETFs—Tax Rates by Structure

| Fund Legal Structure | Max. Long-Term Tax Rate | Max. Short-Term Tax Rate |
|---|---|---|
| LP | N/A | N/A |
| Grantor Trust | 15% | 35% |
| ETN | 15% | 35% |
| UIT | 15% | 35% |
| Open-End Fund | 15% | 35% |

### Currency Limited Partnerships

Currency funds, like commodity funds, use a limited partner structure when trading derivatives as a means of tracking the underlying instrument. Although futures contracts are the most typical trading vehicle, options, forward contracts, and swaps are sometimes employed.

Currency LP ETFs also share the same taxation rates with commodity LP ETFs. Sixty percent of gains in the currency funds are taxed at the long-term capital gains rate of 15 percent, and 40 percent of the gains are taxed as ordinary income to the individual investor. Again, the ordinary income rate applies irrespective of how long the shares have been held, and the maximum blended rate is 23 percent. Further, currency LP funds issue an IRS form K-1 to the investor for tax reporting purposes.

Several of the more widely traded currency LPs include the PowerShares DB US Dollar Index Bull ETF (UUP), the ProShares UltraShort Yen ETF (YCS), and the ProShares UltraShort Euro ETF (EUO).

### Currency Grantor Trusts

The only fund to use the grantor trust legal structure is Rydex's CurrencyShares. Rydex provides exposure to the underlying currency through holding each foreign currency in foreign bank accounts. Included in Rydex's CurrencyShare family of funds are the CurrencyShares Swiss Franc Trust (FXF), the CurrencyShares Australian Dollar Trust (FXA), and the CurrencyShares Canadian Dollar Trust (FXC).

Gains from all Rydex's CurrencyShares funds are taxed as ordinary income. The maximum ordinary income rate is currently 35 percent. The ordinary income taxation rate applies irrespective of the holding period of the investment (i.e., long-term capital gains rates do not apply).

### Currency Exchange-Traded Notes (ETNs)

Under an IRS ruling put out in 2007 (Revenue Ruling 2008−1), gains realized on currency ETNs are now taxed as ordinary income at a rate based on the individual's tax bracket (maximum rate of 35 percent). The holding period of the currency ETN

plays no role under Revenue Ruling 2008−1. Consequently, both long-term (more than one year) and short-term (less than or equal to one year) gains are taxed as ordinary income. However, there is debate by several currency ETNs that individual investors may have the ability to claim a capital gains status for some of their distributions under IRS code Section 988.

Another interesting twist with respect to currency ETN taxation is the fact that if a note generates annual income, the ETN investor must pay taxes on the undistributed income each tax year. Remember, ETNs do not issue distributions, so investors must pay the tax liability from other sources of funds.

The Market Vectors Chinese Renminbi/USD ETN (CNY) and the iPath EUR/USD Exchange Rate ETN (ERO) are two examples of currency funds that fall under the legal structure of exchange-traded notes.

### Currency Open-End Funds

The only ETP issuer to offer "open end" currency ETFs is WisdomTree. The WisdomTree family of open-end currency funds includes the WisdomTree Dreyfus Japenese Yen Fund (JYF), Brazilian Real Fund (BZF), Chinese Yuan Fund (CYB), Indian Rupee Fund (ICN), South African Rand Fund (SZR), Emerging Currency Fund (CEW), and the Commodity Currency Fund (CCX).

The WisdomTree currency funds are structured such that they hold mainly U.S. Treasury bills and repurchase agreements (repos). Repos are a form of short-term borrowing often used by banks and investment companies. Essentially the terms of a repurchase agreement (repo) require that the seller of the security (borrower) repurchase the security from the seller (lender) for an agreed-upon price and time (usually one to three days). The WisdomTree currency funds obtain exposure to the various currencies through the use of swaps and forward currency contracts. Forward currency contracts are an agreement between two parties to exchange two currencies at a fixed rate of exchange at a specific time in the future. The time frame is usually, 30, 60, or 90 days. They are used to mitigate foreign exchange risk.

Per the WidomTree prospectuses, all gains on these funds are taxed as long-term capital gains if shares are held for greater than one year (15 percent rate for long-term capital gains). If shares are held for one year or less, the gains are taxed at ordinary income rates (maximum 35 percent).

Tables 11.3 and 11.4 provide an easy-to-use visual for understanding the types of currency ETFs, their legal structures, and the tax consequences associated with each type.

## Other Alternative Funds

The final category of ETF fund is alternative funds. Alternative funds are structured as LPs, ETNs, and open-end funds. These types of funds seek to provide the investor

**TABLE 11.3** Currency ETF Legal Structure and Fund Strategy

| Fund Structure | Open End | Limited Partnership | Grantor Trust | ETN |
|---|---|---|---|---|
| Governing Act | 1940 | 1933 | 1933 | 1933 |
| Issuing Firm | Wisdom Tree | Rydex | ProShares, PowerShares | Barclays, VanEck, PowerShares |
| Distributions | Annually | Annual | Monthly | N/A Embedded |
| Fund ETFs | BZF, CYB, YF | UUP, YCS, UDN | FXA, FXE, FXF | ERO, CNY, JYN |
| Fund Strategy | Invests in short-term securities and nondeliverable forward currency contracts. | Holds futures, swaps, options, or forward agreements | Holds physical currency in foreign bank account. Deposit earns a local interest rate. | Structured note. Promise to pay an amount based on value of currency relative to USD plus interest at specific date. |

**TABLE 11.4** Currency ETF Tax Rates by Legal Structure

| Fund Structure | Open End | Limited Partnership | Grantor Trust | ETN |
|---|---|---|---|---|
| Issuing Firm | Wisdom Tree | Rydex | ProShares, PowerShares | Barclays, VanEck, PowerShares |
| Distributions | Annually | Annually | Monthly | N/A Embedded |
| Fund Offerings | BZF, CYB, YF | UUP, YCS, UDN | FXA, FXE, FXF | ERO, CNY, JYN |
| Taxation %'s (Max LT/ST Rates) | 15/35 | 23/23 (maximum blended rate) 60% of gains taxed at LT capital gains rate and 40% of gains taxed as ST gains (ordinary income based on taxpayer's tax bracket) | 35/35 | 35/35 |
| Tax Document | 1099 | K-1 | 1099 | 1099 |

with access to unique trading strategies or asset classes. They are often used for portfolio diversification.

Alternative exchange-traded products include all types of asset exposure that do not fall under the definition of commodity, fixed income, equity, or currency ETPs. They include such strategies as funds that combine both bullish and bearish market strategies. Alternative ETFs provide access to sophisticated trading strategies for the average investor.

For instance, some utilize a portfolio strategy referred to as "130/30." Under this strategy, the fund uses leverage to build a portfolio that is 130 percent long and 30 percent short. This type of strategy is often used by hedge funds to gain exposure to both the long and short side of the market. Examples of funds using this strategy include the ProShares Credit Suisse 130/30 (CSM) and the First Trust Enhanced 130/30 (JFT).

Other alternative funds include global macro, futures, merger arbitrage, long-short funds, volatility funds, and "Buy/Write" (covered call) funds. Included in these categories are the iShares Diversified Alternative Trust (ALT), IQ Hedge Macro Tracker (MCRO), IQ ARB Merger Arbitrage (MNA), iPath CBOE S&P 500 Buy/Write ETN (BWV), PowerShares Nasdaq 100 Buy/Write (PQBW), iPath S&P 500 VIX Short-Term Futures ETN (VXX), iPath S&P 500 VIX Mid-Term Futures ETN (VZX), PowerShares DB G10 Currency Harvest Fund (DBV), iShares Diversified Alternatives Trust (ALT), and ProShares (VIX) Short-Term Futures Fund (VIXY).

Taxation of alternative funds is similar to that for commodity and equity fund structures. For example, open-end funds are taxed like equity funds. Long-term gains are taxed at 15 percent and short-term gains are taxed as ordinary income (35 percent maximum marginal tax bracket). If an alternative fund holds futures contracts, the gains are taxed at the blended 60 percent/40 percent rate. As discussed earlier, the blended rate applies irrespective if the fund is held for greater than or less than one year. The blended rate is 23 percent (assumes a maximum marginal tax bracket of 35 percent). ETNs that fall under the alternative category are taxed the same as equity ETNs. But remember that gains on all currency ETNs, including alternative currency ETNs, are taxed as ordinary income. The holding period is irrelevant. See Table 11.5.

## Additional Tax Issues for ETFs—Taxation of Distributions

Taxes on ETFs are paid as both long-term capital gains when the fund is held for greater than one year and the shares are sold and when periodic distributions of

**TABLE 11.5** Other Alternative ETFs—Tax Rates by Structure

| Fund Legal Structure | Max. Long-Term Tax Rate | Max. Short-Term Tax Rate |
|---|---|---|
| LP | 23% blended rate 60% of gains taxed at LT capital gains rate and 40% of gains taxed as ST gains (ordinary income based on taxpayer's tax bracket) | 23% blended rate 60% of gains taxed at LT capital gains rate and 40% of gains taxed as ST gains (ordinary income based on taxpayer's tax bracket) |
| Grantor Trust | N/A | N/A |
| ETN | 35% | 35% |
| UIT | N/A | N/A |
| Open-End Fund | 15% | 35% |

**TABLE 11.6** Dividend Taxation (Qualified and Unqualified) United States: 2003–Present

| 2003–2012 | | | | | 2013– | | |
|---|---|---|---|---|---|---|---|
| | 2003–2007 | | 2008–2012 | | | 2013– | |
| Ordinary Income Tax Rate | Ordinary Dividend Tax Rate | Qualified Dividend Tax Rate | Ordinary Dividend Tax Rate | Qualified Dividend Tax Rate | Ordinary Income Tax Rate | Ordinary Dividend Tax Rate | Qualified Dividend Tax Rate |
| **10%** | 10% | 5% | 10% | 0% | **15%** | 15% | 15% |
| **15%** | 15% | 5% | 15% | 0% | **28%** | 28% | 28% |
| **25%** | 25% | 15% | 25% | 15% | **31%** | 31% | 31% |
| **28%** | 28% | 15% | 28% | 15% | **36%** | 36% | 36% |
| **33%** | 33% | 15% | 33% | 15% | **39.6%** | 39.6% | 39.6% |
| **35%** | 35% | 15% | 35% | 15% | | | |

*Source:* http://www.irs.gov/pub/irs

income are made by the fund. Most funds distribute income monthly or annually. Distributions can take the form of dividends (paid by underlying stocks to the fund), interest on bonds, and capital gains. As discussed earlier, capital gains can be long term or short term, and each is treated differently (in most instances) for tax purposes.

Payment of dividends typically occurs monthly, quarterly, semiannually, or annually. What's most important, however, is not when they occur, but rather the distinction between qualified and nonqualified dividend payments. See Table 11.6.

Qualified dividends are dividends that are paid by a U.S. company to any ETF that has held those shares for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. Note that the 60-day holding period includes the day the underlying stock was sold by the fund but not the day it was purchased by the fund. The ex-dividend date is defined as the first day following the declaration of the dividend on which the buyer of an underlying stock (the fund) is NOT entitled to receive the next scheduled dividend payment Specifically, the holding period references the shares held by the exchange-traded fund and not the individual. It has nothing to do with the time period that the individual investor holds the ETF in his or her portfolio.

Qualified dividends hold a tax advantage over nonqualified dividends. Specifically, they are taxed at a much lower rate. The maximum rate for qualified dividends is 15 percent. On the other hand, nonqualified dividends are taxed as ordinary income. There is an important distinction that must be made with respect to bond funds, however. Do not confuse the distributions from bond funds (dividends) with interest income earned from the underlying investments. Interest earned is considered ordinary income (not qualified dividends) by the IRS and is taxed at a higher rate, which is based on an individual's marginal tax bracket. The same nonqualified

status holds true for currency funds. Any interest yielded from these funds is taxable as ordinary income.

## Distributions in Excess of Earnings and Profits

Exchange-traded funds also pay out distributions known as return of capital or ROC. According to the IRS website,

> Distributions that qualify as a return of capital are not dividends. A return of capital is a return of some or all of your investment in the stock of (investment in) the company. A return of capital reduces the basis of your stock (ETF). For information on Basis of Assets, refer to Topic 703. A distribution generally qualifies as a return of capital if the corporation (fund) making the distribution does not have any accumulated or current year earnings and profits. Once the basis of your stock (ETF) has been reduced to zero, any further non-dividend distribution is capital gain.

Therefore, return of capital (ROC) is not taxable since it reduces the cost basis of the investment by the amount of the distribution. Typically, only real estate investment trusts (REITs) and master limited partnership funds (MLP) participate in ROC distributions.

All forms of distributions paid by ETFs are detailed in IRS form 1099-DIV. This form is provided to all investors by the individual fund and includes a breakout of qualified and nonqualified dividends, short-term capital gains, and long-term capital gains. ROC distributions also appear under "nondividend distributions" on form 1099-DIV.

## Which ETP Is Best for Me? Tax Objectives Matter

Tax implications are not the only reason to choose a particular ETF as an investment vehicle, but they obviously play an important role in the process. Probably the most important information you can take away from this chapter is that there are numerous ETP investment options and each of those options carries its own unique tax implications based upon the legal structure and the asset class of the fund.

It is well beyond the scope of this book to evaluate all the tax ramifications associated with various ETPs. That job is better suited for a professional tax advisor. However, for the purpose of establishing a framework by which you can do your own evaluation of which ETFs are best for your tax situation, let's take a look at several tax implications associated with commodity ETFs and currency ETFs.

The holding period is an important consideration with respect to taxation. As we've already discussed, the IRS taxes long-term capital gains at a lower rate than ordinary income (short-term gains). Therefore, for investors in a high tax bracket who desire to invest in an ETF for a short period of time, commodity funds structured as limited partnerships may be the wise choice. Remember, commodity

limited partnerships invest in derivatives contracts and are therefore taxed at a blended rate of 23 percent regardless of the holding period (60 percent of the gains are taxed as long-term capital gains or 15 percent). In other commodity exchange-traded fund structures, short-term gains are taxed at the higher ordinary income rates (maximum of 35 percent).

Investors seeking to hold a commodity ETP for greater than one year may find a tax advantage by investing in a commodity structured as an ETN. As you may recall, ETNs held for more than one year receive the more favorable long-term capital gains treatment (only 15 percent tax rate). Once the holding period exceeds one year, commodity LPs lose their tax advantage.

As we discussed earlier in the book, the WisdomTree currency funds carry an open-end legal structure and per the WidomTree prospectuses, all gains on these funds are taxed as long-term capital gains if shares are held for greater than one year (15 percent rate for long-term capital gains). If shares are held for one year or less, the gains are taxed at ordinary income rates (maximum 35 percent). Although it does not relate to taxes, a potential disadvantage of WisdomTree's funds is that they utilize forward contracts to track the underlying instrument, and therefore they may not follow spot exchange rates as well as other options. Rydex's CurrencyShares is considered by many to be the best way to gain exposure to currencies and avoid the tracking error associated with forward contract–based funds. All gains in the Rydex family of currency funds are taxed as ordinary income. The maximum ordinary income rate is currently 35 percent.

Currency LPs offer the same advantage as commodity LPs for short-term investors since they offer the lower, blended 23 percent rate. However, some investors dislike dealing with the K-1s associated with LPs, since they often result in higher tax preparation costs.

Ultimately, you should consult a professional tax advisor when considering the tax implications of various ETPs. We are not tax professionals, nor do we provide tax advice. However, we felt it was important to provide a simple but logical framework for understanding and evaluating the potential tax consequences associated with various exchange-traded products.

*Advanced Technical Analysis of Etfs: Strategies and Market Psychology for Serious Traders*
by Deron Wagner, Edward Balog


# PART VI

# Where to Go From Here

# CHAPTER 12

# Trading Is a Journey, Not a Destination

Finding a winning and proven trading strategy that works is only one small part of being a consistently successful and profitable trader. Just as important, perhaps even more so, is one's ability to have patience and extreme discipline to follow the methodology. You say you already are patient and disciplined? For most traders and investors who are honest with themselves, this is an extremely challenging task that requires constantly keeping one's ego, fear, and other powerful emotions in check. That's why we devoted two entire chapters of this book to just the psychology of trading.

So far, we have taught you several new technical indicators, some of which may be confusing on the surface and take a bit of time to master. You have also seen, from our 30 trade examples, reinforcement that just the basic top-down strategy is profitable, even without the additional indicators that only improve and increase your odds of success.

Overall, a very basic trading strategy can be successful, but realize that every additional piece of the puzzle you learn, such as a new technical indicator or psychological concept, will only increase your likelihood of being a winner. But even if we removed everything in the book prior to this chapter, you will still be left with the absolute best single piece of advice we can give you: Don't seek the Holy Grail!

The number of traders who approach us searching for a "silver bullet" or "Holy Grail" that will quickly and easily transform their trading is intriguing. Unfortunately, trading is much more complex than that. Another faulty variation of this thought process is that many traders also feel if they can't be successful in trading ETFs or stocks, they will surely make it big when they make the switch to trading the right instrument, such as currencies, commodities, or futures contracts instead.

If you're serious about your success as a trader of ETFs or any other instrument, it is imperative that you immediately start taking full responsibility for your financial results and realize there is no Holy Grail (the sole mythical, magical element that will lead you on the pathway to enlightenment).

## Four Key Elements of Success

So if being a consistently profitable trader is not the result of finding the Holy Grail, what exactly does it take? We feel there are four key elements for success:

1. Maintain and utilize a strict set of trading rules—Specific trading rules, such as when to buy, when to sell, and how much risk to take on every trade, are obviously the foundation for developing any winning trading strategy. If you remove any one of these elements, your trading methodology will be full of holes and ineffective. In this book, we delved into all the building blocks of developing an effective trading strategy; nevertheless, our strategy and rules are not enough for a trader to be successful.
2. Implement and follow a strict money management system—You could have the most successful trading strategy in the world, but the system would be doomed to failure if deployed without clearly defined rules for money and risk management. Throughout this book, we provided numerous examples of how our predetermined stop loss on every trade defines and limits our capital risk before entering the trade. Additionally, it's also important to set a protective stop loss that specifically limits your risk per trade as a percentage of total capital in your trading account.
3. Have a tracking system for monitoring and analyzing trade results—While this is one element of success we did not discuss in the book, keeping a record of trade statistics and a trading log is the only way you'll know where your strengths and weaknesses lie.

   In my beginning years as a trader, I thought I was doing everything correctly, yet was losing money regardless. It was not until I actually began taking a detailed, written account of when and where I bought and sold every position that I began to gain a clear understanding of my areas for improvement. You can keep as much or as little detail as you like, but the most important thing is to just get in the habit of at least recording the basic details of every trade, so you will have a reference point for calculating key statistics such as winning percentage and average gain vs. average loss.

   Way back in school, I used to have a teacher who would say, "Performance measured is performance gained." At the time, I did not possess a full appreciation for the meaning of that phrase. However, now that I am a professional trader, those words resonate in my head on an almost daily basis.
4. Have the psychological discipline, conviction, and stamina to consistently follow your rules—The psychology of trading was discussed extensively in Chapters 8 and 9, so we won't be redundant. Just remember that the most important psychological element of being a trader is not only understanding the four main emotions that move markets, but having the ability to be honest with yourself about which of those four emotions may be your Achilles heel, then immediately setting to work on improvement.

Only when you have mastered all four of these elements will you become a consistently successful trader, so understand *there is no Holy Grail*. Rather, there is a strict set of disciplines that must be mastered in order to become successful.

## The Big Misconception

One common misconception about trading is that being profitable over the long term requires a high percentage of winning trades. This simply is not the case. While some trading strategies may have a high percentage of winning trades, there are others that have winning percentages of even less than 50 percent and are still net profitable year after year. How can that be?

It all comes down to making sure your strategy has a small, albeit consistent, mathematical edge, and exploiting that edge time and time again. In the end, this leads to consistently profitable trading. It's analogous to card counting in blackjack, where the professional is only gaining a small mathematical edge of around 1 percent (of course, depending on specific casino rules), but big profits can be realized over the long term due to the continual accumulation of gains from that small mathematical edge.

## The Two Ratios to Know

Generally speaking, there are two main mathematical ratios that dictate whether or not one's strategy will be profitable over the long term: average winning percentage *and* the dollar amount of the average winning trade compared to the average losing trade (profit/loss ratio). The lower either number is, the higher the other one must be in order to have a net profitable trading system.

If, for example, your winning percentage is 50 percent, and your average winner is the same size as your average loser, you would basically be breaking even over the long term (not factoring in the negative effect of brokerage commission fees). If your average winning percentage is 50 percent, your average trading win must be larger than your average trading loss in order to be net profitable. It is possible to have a winning strategy even if your average losing trade is larger than your average winning trade . . . just as long as your winning percentage is substantially greater than 50 percent. Conversely, we even know traders who have a winning percentage of less than 50 percent, yet they're still net profitable because their average winner is much greater than their average loser. This would occur when a trader takes a trade with a positive reward-to-risk ratio, then lets the winners ride, while cutting off the losing trades at the predetermined stop losses.

Since Morpheus Trading Group (morpheustrading.com) was founded in 2002, the percentage of winning trades in our newsletter has been approximately 57 percent. By extension, this means that about 43 percent of our ETF and stock trade entries have resulted in losses. Nevertheless, the cumulative net return of our detailed

ETF and stock picks (swing trades) for subscribers over the past 10 years is quite substantial, several times greater than the accumulated return of the main stock market indexes (detailed historical trade performance statistics available on our website). This is because we have carefully managed our trades in such a way that our average winner has historically been much greater than our average loser, typically just under a 2 to 1 ratio. This clearly proves that a high percentage of winning trades is *not* necessary in order to make consistent trading profits. However, what is required is honoring stops, staying in winning trades to maximize profits, and monitoring your trade performance, so that you can determine if your ratios will combine to formulate a positive outcome (as discussed earlier in this chapter).

## The Journey to Success

*Becoming a successful trader is a perpetual journey, not a destination*. Although we have been utilizing and refining our strategy for more than a decade, we continue to learn and improve on existing techniques every day. What's most important is that you continually look to improve your trading skill set through following your trading plan and seeking the help and guidance of others who have already dealt with the mistakes that many beginning and intermediate traders make.

Learning on your own has several benefits, but the school of hard knocks can be quite costly in the trading business, especially if you're just getting started. On the other hand, it is always beneficial and wise to seek the expertise of other successful traders, such as those who offer quality, educational Internet-based ETF and/or stock analysis. In doing so, you will find many different styles and strategies being promoted, some of which obviously work better than others. But in particular, there is one red flag to be on the lookout for . . . wild or unsubstantiated claims.

You will likely encounter stock-picking newsletters, blogs, or chat rooms that promote an unusually high annualized return, but without clearly reporting the actual outcome of all trades that enabled such a high return. Similarly, you may find services that trumpet a high winning percentage of trades, such as 80 percent, but without telling you the amount of the average winner compared to the average loser of each of those trades. Without this information, it is impossible to determine whether or not the strategy being taught can be successful. Therefore, we strongly recommend you select a swing trading newsletter service that actually tracks and reports the performance of *all* (not only winning) past trades.

As previously mentioned, we at Morpheus Trading Group have been transparently reporting the performance of *every* swing trade taken in the model portfolio of our newsletter, *The Wagner Daily*, since 2002 (we trade both ETFs and individual stocks utilizing our strategy). All the key ratios of our historical trade performance are openly on display, thereby unequivocally proving that the strategy and methodology taught in this book . . . *works!* Furthermore, it is also notable that we trade real money with this strategy; we are not just teachers.

If you visit our website at morpheustrading.com, be sure to check out our swing trading blog. Filled with enlightening trading articles, videos, ideas, and resources, our blog is the free trader education arm of our premium newsletter, *The Wagner Daily*. In addition to our newsletter, we also offer a comprehensive online video course, *Swing Trading Success*, which was built on the strategies taught in this book. Finally, we offer our exclusive global ETF and stock screener software that identifies potential trades, based on the methodology taught in this book. The combination of these services is designed to get you fully up to speed as a serious swing trader in the most efficient manner, and without all the nonsense and hype that's prevalent in the trading industry.

We personally hope you enjoyed this book, and that you will utilize the strategies taught to improve the profitability in your own personal trading. Should you have any questions about anything you have read in this book, please feel free to send an e-mail to editors@morpheustrading.com and Deron, Ed, or a member of our team will be happy to help you out. However, please be patient waiting for a response, as we receive a lot of e-mail from our members every day. Wishing you success in your every endeavor, and good trading to you!

*Advanced Technical Analysis of Etfs: Strategies and Market Psychology for Serious Traders*
by Deron Wagner, Edward Balog


# About the Authors

**DERON WAGNER** is the founder of Morpheus Trading Group (morpheustrading .com), an Internet-based trader education and capital management firm he launched in 2002. Since inception of MTG, he and his team have helped thousands of people around the world become successful and consistently profitable traders in the stock markets. He is the author of *Trading ETFs: Gaining an Edge with Technical Analysis* (Bloomberg Press, 2008), *Sector Trading Strategies* (Marketplace Books, 2005), and co-author of *The Long-Term Day Trader* (Career Press, 2002). He has also appeared on CNBC and ABC television networks, is a frequent speaker at various global investment conferences, and is a regular contributor to several popular financial websites.

Currently, Wagner is the head portfolio manager of his firm's Managed Account program, and is also the editor of his popular *Wagner Daily* swing trading newsletter. Splitting his time between Southeast Asia and South Florida, Wagner is happily married with two children. He can be reached at deron@morpheustrading.com.

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