

Step
by
Step



Trading

Dr. Alexander Elder

StockCharts.com

Step by Step Trading

By Dr. Alexander Elder

Copyright 2015 by Dr. Alexander Elder

All charts by StockCharts.com – used with permission.

ISBN: 978-0-9744942-5-8

Published by elder.com

LEGAL: No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means without the prior written permission of the copyright owner.

DISCLAIMER OF WARRANTY: while the author has used his best efforts in preparing this book, he makes no representations or warranties with respect to the accuracy or completeness of the contents. The advice and strategies contained herein may not be appropriate for your situation. You should consult with a professional where appropriate. The author shall not be responsible for any loss.

Books by Dr. Alexander Elder

In chronological order:

Trading for a Living

Study Guide for Trading for a Living

Rubles to Dollars

Come into My Trading Room

Study Guide for Come into My Trading Room

Straying from the Flock: Travels in New Zealand

Entries & Exits: Visits to 16 Trading Rooms

Study Guide for Entries & Exits

The New Sell & Sell Short (with Study Guide)

To Trade or Not to Trade: A Beginner's Guide (e-book)

Two Roads Diverged: Trading Divergences (e-book)

The New High – New Low Index (e-book), with Kerry Lovvorn

Additive Manufacturing (e-book)

The Trading Puzzle – Book One (e-book), with Kerry Lovvorn

The New Trading for a Living

Study Guide for The New Trading for a Living

Table of Contents

[Free updates and the honor code](#)

[Starting Out on Your Journey](#)

[Markets are tough](#)

[Two steps that will put you ahead of the crowd](#)

[How to control risk](#)

[Good records make good traders](#)

[Technical Analysis](#)

[StockCharts Basics](#)

[Let's create a chart \(actually, two charts\)](#)

[Dressing a naked chart: a pair of moving averages](#)

[Profits from manic-depression \(using envelopes\)](#)

[The power of bulls and bears \(MACD indicator\)](#)

[May the force be with you \(Force index\)](#)

[Less is more \(other indicators\)](#)

[Trading Systems](#)

[The trades to avoid \(the Impulse system\)](#)

[Every trade deserves a name \(the system you trade\)](#)

[Buying pullbacks in an uptrend](#)

[Catching reversals \(false breakout with a divergence\)](#)

[An end-of-day trend-following system \(by Kerry Lovvorn\)](#)

[Trading with fundamentals and technicals \(by Philip Wu\)](#)

[Trade Management](#)

[The sweet spot \(what timeframe will you trade?\)](#)

[Stops, targets, and risk control](#)

[Your visual diary](#)

[The road ahead](#)

[Sources](#)

[Acknowledgments](#)

[About the author](#)

Free updates and the honor code

After we accumulate feedback for this e-book, we plan to issue an updated edition and send it at no charge to all purchasers. If you bought this book from Elder.com, you'll automatically receive an update. If you bought it elsewhere, please [let us know](#), and we'll add your email to our list for future updates. We have a strict privacy policy and will never release your information to anyone.

Please **do not forward this book** to your friends (i.e. commit piracy). Instead, [email your friends this link](#) to make sure they receive the latest update.

Please do not copy this book.

I put several hundred hours of work into writing. Please reciprocate my trust in you by sending your friends the above link rather than pirating the book.

And now, let's embark on our journey.

Dr. Alexander Elder

Vermont, March 2015

[Return to the top](#)

Starting Out on Your Journey

Congratulations on becoming a StockCharts.com member. You have taken an important step towards becoming a successful trader. This book will guide you through the next several steps. My goal in writing it was to help you avoid common pitfalls and master the key principles that will serve you for the rest of your trading life.

Most beginners jump into trading unprepared. They remind me of new skiers who hop into a gondola and ride to the top of a mountain without a clue how to ski down its slopes. This book will teach you the essentials of modern computerized trading. Even if you already have some experience, you'll find much that is useful and perhaps even surprising in this book.

To help you focus on the process of becoming a successful stock trader, I've included the key lessons from my years of experience. This book, *Step by Step Trading*, will walk you through the essentials of this fantastically interesting but demanding craft and teach you its main do's and don'ts. I believe that "less is more" in trading. Most traders needlessly complicate their work and hurt their results instead of improving them.

I suggest reading this brief book at least twice. Begin by loading it onto your favorite tablet or printing it out and read it once the old-fashioned way, relaxing in your favorite chair. Then go back and re-read it while sitting in front of your StockCharts screen, and implement its lessons. This will ensure that you absorb all of the essential information in this book.

We'll begin by looking at the risks of trading and then set the essential money management rules. We'll continue our journey of discovery by going step-by-step through the exact chart settings that I use – and of course explain how and why I use them. There is no need to waste time re-inventing the wheel if you can benefit directly from my years of experience.

After that, I'll show you several examples of trading systems and trade management techniques. I'll even give you a copy of the spreadsheet that I use to track my own trades. Take your time working with this book to become a more knowledgeable and more disciplined trader.

Throughout this book you'll find boxes like this one - they contain precise instructions on how to duplicate my settings on your computer. If you are on the first reading of this book, you can skip these and focus on the actual text. Later, when you are in front of your computer, follow these instructions – step-by-step – to get your StockCharts account configured just like mine.

[Return to the top](#)

Markets are tough

Trading attracts us with its promise of money and freedom, challenge and excitement. Beginners quickly discover how hard it is to take profits out of the market. Remember, the only easy thing about trading is losing money!

The rewards of trading as well as its dangers are both are very real and you need to weigh them before you jump in with both feet. If you decide to trade, you have a fascinating road ahead of you. If you decide that trading is not for you, there is no shame in “Let me stand aside from the markets for now.”

Before we analyze charts and look for stocks to buy or sell, let's explore several basic questions: what markets to trade, how to manage risk and why keep a trading journal.

Where will your trading profits come from? The money you hope to take out of the markets currently resides in other people's accounts. And all those men, women and corporations have absolutely no desire to give money to you. As a matter of fact, right now, while you're reading this book, they're crafting their trading plans, designed to take your money.

While you're planning to pick their pockets, they're working hard on trying to pick yours. They're probably more experienced in this game than a beginning trader. But your forthcoming

battle with them isn't even your biggest problem.

Your greatest enemy – a bigger obstacle than any competitor, a grasping broker, or unstable internet – is the person you see every morning in the mirror.

All beginners – and quite a few experienced traders who should know better – sabotage themselves in ways that are sometimes sad, at other times hilarious, but almost always avoidable. And they do it not once or twice, but over and over again, until their account is depleted or they lose confidence and slink away from the markets.

The lack of knowledge, or to put it bluntly, ignorance, isn't the biggest cause of trader mortality. The two major causes of losing are the inability to control risk and to manage yourself. If you learn to manage yourself in the markets and to control risks, you'll ensure that you have enough time to survive, clear up any lack of knowledge, and start taking profits from the markets.

Most people hate to face their own role in losing. This is why, if you want to become a successful trader, you need to learn to manage yourself: write trading plans, calculate risks vs. rewards, and complete your trading journal after each trade. Then you'll rise above the masses and start taking money from the markets.

The rules for managing risk that I'll show you may feel annoying for beginners with tiny accounts, because proper risk control limits trade size. Our greed pushes against risk management. All traders have this powerful emotion – some of us have a lot and others an even bigger lot.

Another hugely powerful emotion is fear, and it follows on the heels of greed. You get greedy, put on an oversize trade, the market slaps you – and now fear kicks in. You become afraid to put on a perfectly reasonable trade – and afterwards kick yourself for having missed an opportunity. Poor risk management makes people lose courage as well as money.

This is why I want to begin this book on trading tools and systems with brief chapters on risk

control and self-management.

[Return to the top](#)

Two steps that will put you ahead of the crowd

The two key skills that separate winners from losers are risk control and self-control.

Managing risk in your account is pretty straightforward once you know the formulae, which you're about to see. A professional trader may allocate up to a third of his research time to calculating money management angles, as he compares risks and rewards for different stocks. He discards many stocks that look attractive but whose risk parameters don't suit him.

How much time does an average beginner spend calculating and managing risk? Most likely zero, zip, nada. Right before placing a trade he may briefly scratch his head or some other part of his anatomy and decide to double his usual size because he made money in the previous trade or skip this trade because he lost money in his previous trade. Both choices are equally wrong. If you let your latest trade determine what size to trade next time, it means giving up control of trade management. If you follow the formulae in this book for controlling risks, you'll accomplish a goal in which most beginners fail.

The second essential skill – self-control – is harder to quantify. Fortunately there is a clear and concrete tool for implementing and measuring self-control: keeping good quality trading records.

After *Entries & Exits*, my book of interviews with traders, was published, people kept asking what those traders had in common. The 16 traders in the book – men and women, long-term and short-term traders, stocks, futures and options traders, American and foreign traders – what did they have in common?

They all kept excellent records.

I say to my students: “Show me a trader with good records, and I'll show you a good trader.

Show me a trader with poor or nonexistent records, and I'll show you an average trader. And that's a very poor sight because an average trader loses money. The majority must lose in order for a small, informed, and disciplined minority to make profits. We'll pay attention to record-keeping as well as risk management in this book.

[Return to the top](#)

How to control risk

An intelligent scuba diver always keeps an eye on his air tank's pressure gauge to make sure he has enough to return to the surface, with a safety margin. The money in your trading account is your air supply. Watch it, be economical in its use, and have a reserve.

All beginners, no matter how bright, make mistakes and take losses. Be sure to keep your losses small, don't let them threaten your survival.

The most important rule of risk control is **THE TWO PERCENT RULE**: never risk more than 2% of your account equity on any given trade.

Begin by writing down three numbers for every trade: your entry, target and stop. Without them a trade turns into a gamble – and you're not here to gamble, are you?

Later, in the chapters on technical analysis, we'll discuss how to set these three numbers. At this point, simply recognize that every trade requires a stop and that the distance from your entry to that stop determines how many dollars you'll risk per share.

Let's say you plan to buy a stock at \$30 and expect it to rally to \$35 – that is your target. As a cautious person and not a gambler, you decide to place a protective stop at \$28 – the level you set through technical analysis, to be discussed later. Buying at \$30 and protecting at \$28 means you'll be risking \$2 per share in this trade.

Next question: how much money do you have in your trading account? Let's say you have

\$20,000. What is 2% of \$20,000? It is \$400 – and that’s the maximum amount you’re allowed risk on any trade.

Next question: how many shares of that stock may you buy? Well, if your maximum permitted risk is \$400 and your risk per share is \$2, you may buy up to 200 shares. You may buy fewer shares but you may not go above the number given to you by the 2% Rule.

The maximum number of shares you may buy is determined by your risk per share and your total permitted risk.

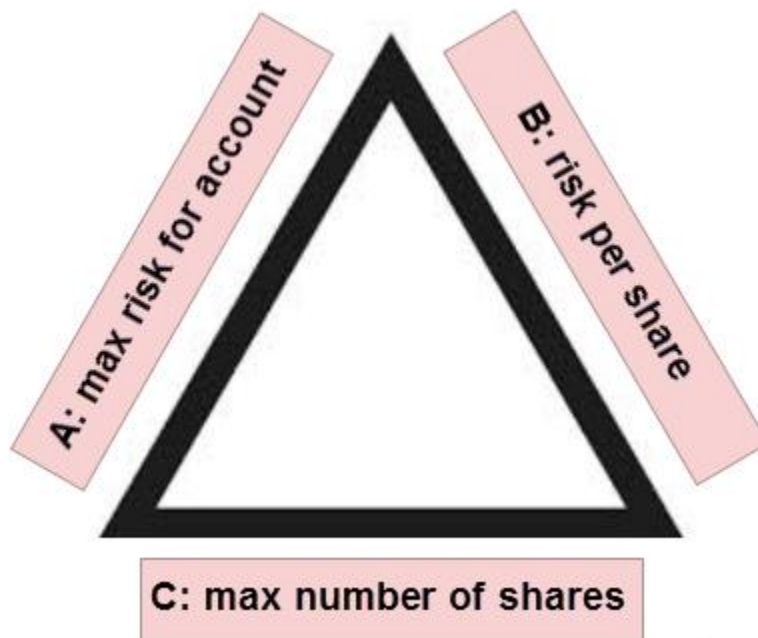


Figure 01. The Iron Triangle of Risk Control

The Iron Triangle of Risk Control: “A” is the maximum risk for your account (2% of its current value); “B” is your risk per share (the distance from your entry to your stop); “C” = A divided by B.

You don’t have to risk 2% of your account on every trade – you’re perfectly welcome to risk less, but you may never risk more. The bigger your account, the lower percentage you want to

risk.

THE SIX PERCENT RULE states that you must stop trading for the rest of the month whenever your losses reach 6% of your account equity at the beginning of that month.

If and when losses start piling up, take that as a sign that your method isn't working in the current market environment. It's time to pause and step aside for a while. Once your drawdown hits 6%, that's the end of trading for the current month – no new trades.

This is similar to placing a stop on a trade – the 6% Rule places a stop on your account, limiting the maximum damage that can be caused by a series of losing trades. The 6% Rule breaks losing streaks, giving you time to think and regroup.

Most traders get killed by fish – either a shark bite (a single disastrous loss) or piranha bites (a series of losses, none of them lethal, but together they shred an account to the bone). The 2% Rule will protect you from the sharks. The 6% Rule will save you from the piranhas.

You may never increase those limits, but feel free to lower them, especially the 2% maximum loss per trade.

If you use the 2% and 6% rules, a series of only three losing trades can knock you out of the game early in the month. If you reduce your maximum risk per trade to 1%, you'll double the number of trades you may take before being forced to step aside. Lowering your risk per trade to 1% or less will give you more latitude to practice your tactics.

Before we close this chapter, a quick comment on account size. A tiny account makes it very hard to diversify, while large accounts tend to lull beginners into a false sense of security. At the time of this writing, I'd say that the sweet spot for beginners is somewhere in the \$20,000 to \$50,000 range. It is big enough to diversify but small enough not to get carried away.

Remember that an intelligent beginner trades to learn. Imagine going to a dental or an

engineering school: you wouldn't expect to make a living out of it in your first year of schooling. Focus on learning and acquiring skills, become a survival expert. Trade small and keep good records. If you do it right from the start, you'll be making good money later – instead of overtrading, getting hurt near the starting line, and becoming demoralized.

Risk management will make you a safer trader. In the next chapter we'll discuss good record-keeping, a key tool for your growth as a trader.

[Return to the top](#)

Good records make good traders

Remember this rule: “it is OK to make mistakes, but not OK to repeat them.” It reminds me of a Russian saying: “Don't step on the same rake twice.” Many traders keep losing money, repeating the same mistakes.

A habitual loser doesn't remember what he did right and made money or what he did wrong and lost. Had he remembered, he would have done more of the right stuff and stopped repeating the wrong moves.

Let's be realistic: it's beyond human capacity to remember all the nitty-gritty details of trading tools, systems, entries, exits, news reports, and a myriad of other details. That's why we need to write those things down. Successful traders keep good records, review them, and learn from them.

You need to keep both numerical and visual records: a spreadsheet and marked-up charts of your trades. StockCharts gives you a great way to mark up your charts and I'm going to give you a spreadsheet you can use for numerical records. Let's review the spreadsheet first.

You can download the spreadsheet in Excel format by clicking this link:
<http://stockcharts.com/step-by-step-trading/traders-spreadsheet.xlsx>

If you don't have MS Excel, you can download this simplified version:
<http://stockcharts.com/step-by-step-trading/traders-spreadsheet.csv>

Shown below are two lines from my spreadsheet, reflecting a trade I made while working on this book. Notice that in addition to the usual numbers, such as entry and exit dates and prices, gross and net profit or loss, this spreadsheet includes columns for rating the quality of each trade as well as of every entry and exit. I call them buy, sell and trade grades. You have to grade your performance in order to improve it.

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	
Source	Method	Symbol	Quant	l/s	Bought	Date	Comm	Sold	Date	n	Fee	P/L	Net	Buy gr	Sell gr	Trade gr	Upchan	Downch	B - high	B - low	B - close	S - high	S - low	S - close	
self	macd scan	AMT	1,000		92.85	10/17/14	\$3.99	95.24	10/21/2014		\$7.99	\$2.11	\$2,390.00	\$2,375.91	74%	76%	41%	97.09	91.31	93.83	92.50	93.17	95.63	94.01	95.60
self	macd scan	AMT	1,000		92.85	10/17/14	\$4.00	95.16	10/22/2014		\$7.99	\$2.11	\$2,300.00	\$2,285.90	74%	21%	40%	97.09	91.31	93.83	92.50	93.17	96.22	94.87	94.94

Figure 02. Trader's Spreadsheet

- 1: Source** – where I got the idea for this trade. It could be myself, an article or a friend's tip
- 2: Method** – If Source is 'self,' then this is the method I used to find this trade.
- 3: Symbol** – Symbol or ticker
- 4: Quant** – How many shares
- 5: l/s** – Long or short
- 6: Bought** – Purchase price
- 7: Date** – Date bought
- 8: Comm** – Commission (since I first sold one half and then the other, I split this line in two).
- 9: Sold** – Sell price
- 10: Date** – Sold date
- 11: Comm** – Sales commission
- 12: Fee** – Exchange fees
- 13: P/L** – Gross profit or loss
- 14: Net** – Net profit or loss
- 15: Buy gr** – Buy Grade (How far from the day's high did I buy? See below for more)
- 16: Sell gr** – Sell Grade (How far from the day's low did I sell? See below for more)

17:Trade gr – Trade Grade (What percentage of the channel did I capture? See below for more)

18&19:Upchan & Downch – Upper and lower daily channel lines on the day I bought

20,21&22: High, low and close on the day I bought

23,24&25: High, low and close on the day I sold

The all-important Trade Grade reflects the percentage of the price channel that the trade earned or lost. Prices flow in channels like rivers in their valleys. Your trade grade is the percentage of the width of the valley that you captured in your trade. You will see how to construct channels in one of the following chapters.

The **TRADE GRADE:** $(\text{Sell} - \text{Buy}) / (\text{Upper channel line} - \text{Lower channel line})$.

This formula compares your profit (or loss) in a trade to the spread between channel lines on the day you entered that trade. Since the distance from the top to the bottom of a channel reflects a realistic maximum available for a swing trade, the Trade Grade reflects the percentage of the maximum you were able to catch. A grade above 30% makes an A-quality trade. Don't swing for the fences, set reasonable goals; anything above 30% is excellent.

Buy and Sell grades reflect the quality of every purchase or sale. Each of these grades is based on a single bar, measuring how your entry or exit relates to the high and the low points of the day.

The **BUY GRADE:** $(\text{High} - \text{Buy}) / (\text{High} - \text{Low})$

You want to buy as far away from the high and as near the low of the daily bar as possible. If you buy in the lower half of the daily bar, your rating for that buy is over 50%, which is excellent.

The **SELL GRADE:** $(\text{Sell} - \text{Low}) / (\text{High} - \text{Low})$

You want to sell as far away from the low and as near the high of the daily bar as possible. If

you sell in the upper half of the daily bar, your rating for that sell is over 50%, which is excellent.

Your Buy and Sell Grades show where you stand in the never-ending battle against the pros who make a living buying near the lows and selling near the highs. If you buy in the upper half of the bar and sell in the lower half, you're feeding the wolves. Of course no one can definitely tell what will be the high and the low of the day, but getting consistently low ratings is a sign that you're chasing runaway prices and need to tighten your discipline.

The spreadsheet above shows two lines documenting one trade because I purchased that stock in a single trade but sold it in two installments. This is marked by the entry commissions on both lines being boxed together. My Buy Grade was 74%, meaning I bought near the bottom quarter of that day. Notice also that the closing price for that day (Col. 2) is colored green because my purchase price of \$92.85 was below the closing price of \$93.17. This meant that the trade was profitable at closing time – another measure of its quality.

I exited the first half of the trade because I thought the market was becoming topy and wanted to take partial profits. My Sell Grade was 76%, based on the high and low of the sale day, but I sold too early in the day. The stock closed for the day above my sale price, which is why I colored the closing box in Col. 25 in red.

The next day the stock reversed and headed lower. I cut and ran, getting a poor sale grade of only 21%, meaning I sold in the bottom quarter of the day – chasing the trend. Still, the stock continued to decline after I sold and closed below my selling price, earning me a green box in Column 25.

Both Trade Grades were good – 41% of the daily channel for the first sale and 40% for the second. Both were above the 30% level that marks A-quality trades.

I hope you appreciate how much useful information about the quality of trades you can get from analyzing a single line in a spreadsheet. Imagine how much more you can learn from analyzing

dozens of such lines.

In addition to numerical records and ratings of all your trades, it's very educational to keep a visual diary of your trades. Save a picture of your stock and its indicators on the day you buy it and another picture on the day you sell. By reviewing them at a later date you'll be able to see what works well and what doesn't work in your approach to trading. Those snapshots will turn you into your own teacher.

StockCharts makes it easy to maintain a visual diary, combining price charts, indicators and comments. Near the end of this book, after we've reviewed the analytic and decision-making process, I will share with you my visual diary of this AMT trade and show you how to maintain it in StockCharts.

Keeping a visual diary of your trades along with numerical records will set you apart from the pack of competitors. You'll rise above them by having what they don't have: risk management and record-keeping. These tasks aren't nearly as exciting as looking for trades and entering them – but they make all the difference between long-term winning and losing.

Note: For more thoughts on record-keeping, please see my book *The New Trading for a Living*.

[Return to the top](#)

Technical Analysis

StockCharts Basics

Experienced members may well skip this chapter, but please read it carefully if you are a new member of StockCharts. It'll help you to get more out of this book and apply its lessons to your work.

Clicking on any chart in this book will take you to the same chart at www.StockCharts.com (obviously, you need to be online to use this function). There you'll be able to see that chart in a larger format and explore all of its settings.



Figure 03. Your options in StockCharts.

A trader can use StockCharts without paying a dime (A). He or she can even access the site's remarkable ChartSchool (B). Still, membership (C) has its privileges, and the most important of them is that the program can memorize any selections or changes a member makes on his charts. If you add an indicator or change its parameters, the program will remember it, and you won't have to retype everything the next time you log in. You also get more indicators and tools.



To learn to use StockCharts, click on <http://stockcharts.com/videos/> to view a gallery of sharp and practical lessons. They are divided into the following chapters:

- The Basics
- Using SharpCharts
- Additional Analysis Tools
- Using ChartLists
- Using ChartNotes

- Scanning and Alerts

Those videos will help you understand your choices for plotting charts, changing their styles, and creating lists. Be absolutely sure to watch the very first video in “The Basics” chapter – Getting Started with StockCharts.com. Watching that 17-minute video will save you multiple hours down the road.

Let me briefly point out just three of the basic features of StockCharts: Overlays, Indicators, and ChartStyles.

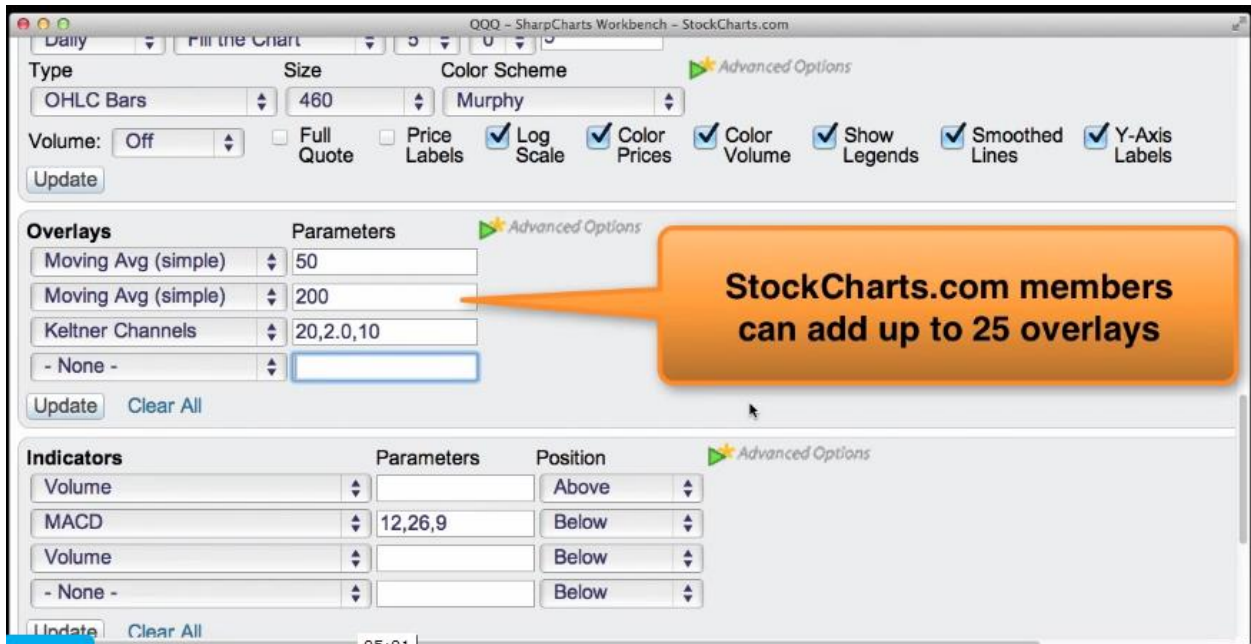


Figure 04. Overlays.

Overlays are studies that are superimposed on price plots, such as moving averages and envelopes (more on those below). StockCharts allows you to have a huge number of overlays, but we’ll stick to the essentials and not clutter our charts.

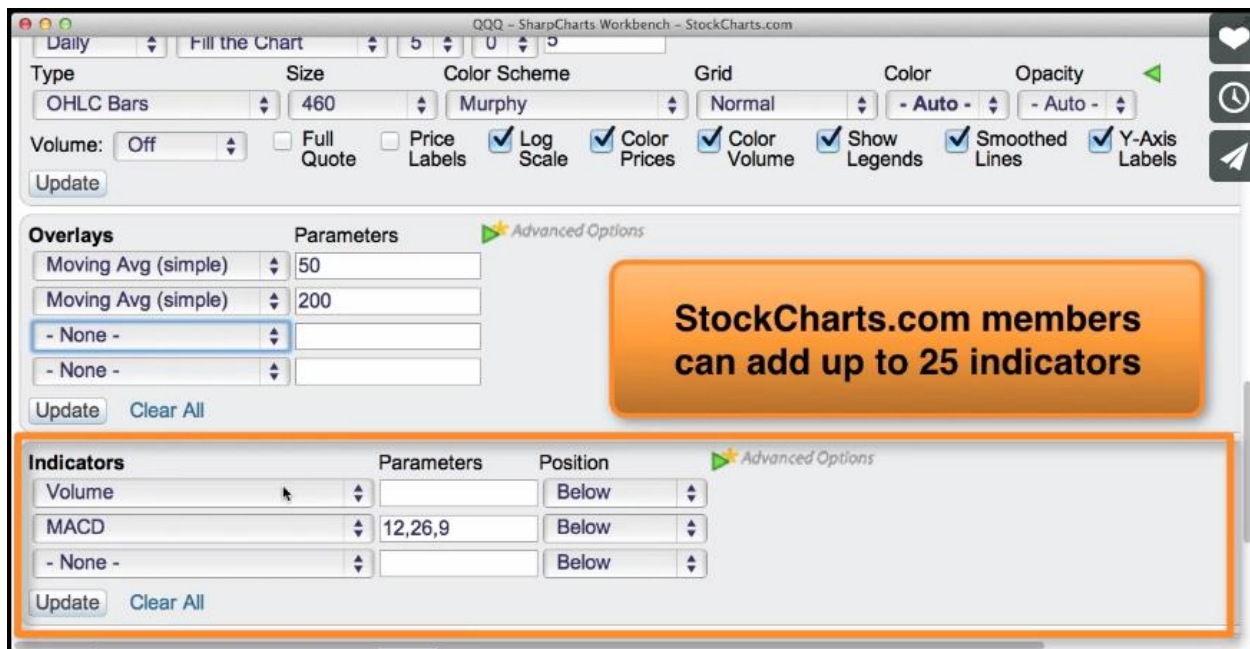


Figure 05. Indicators.

Indicators help us find when bulls or bears dominate a stock. You will see what indicators I use to discover the shifts of power in the endless battles between those two groups. I like plotting my indicators below prices, but that is simply a personal preference. Same as overlays, let's not clutter our charts but select a small number of clear and well understood indicators.

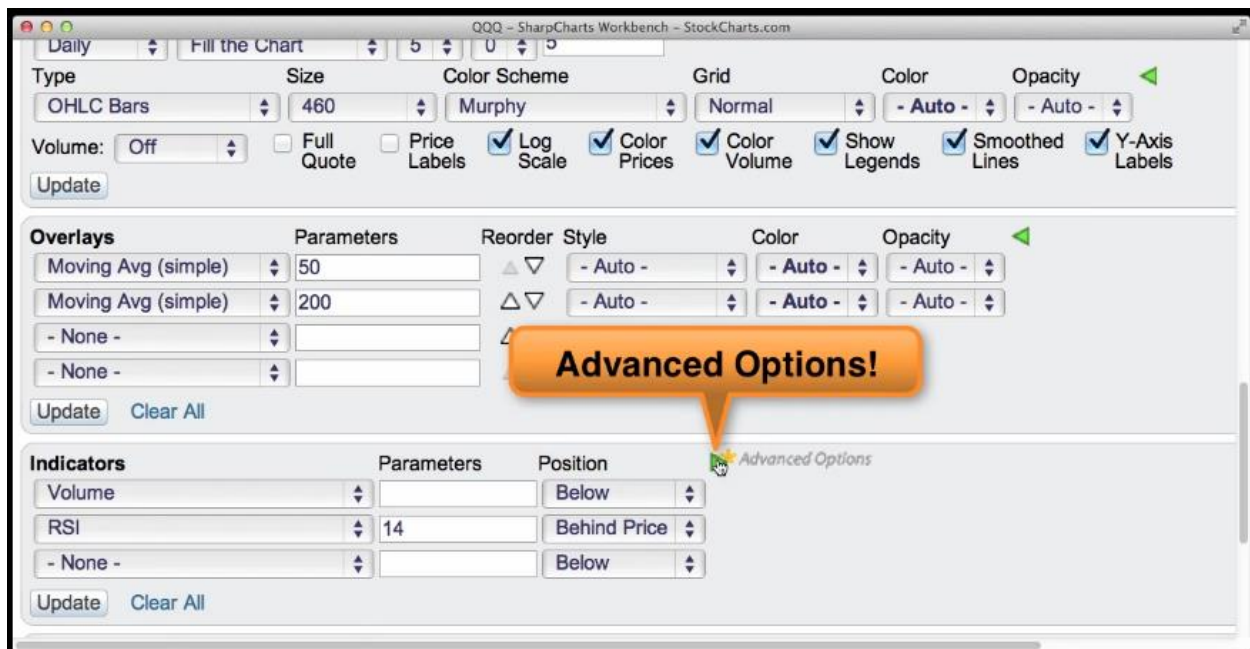


Figure 06. Advanced Options.

Notice that some of the overlays and indicators allow us to use advanced options. Those are marked by green triangles, as shown above. You will see my selections in this book – but feel free to change them, make them your own, with your own unique settings.



Figure 07. ChartStyles.

Arrow A in Figure 07 points to one of the most useful features of StockCharts – a menu of ChartStyles. It gives you the ability to set up a chart exactly how you like and save that format

as a ChartStyle, so that in the future you can apply this template to any ticker with just a single click.

The program also gives you some predefined ChartStyles, including my favorite “Elder’s Weekly Stocks.” Arrow B points to where you can change the ticker and/or timeframe of a chart with a single click.

[Return to the top](#)

Let’s create a chart (actually, two charts)

Every bar or candle you see on your chart represents market action during the period of time covered by that bar or candle. A bar on a daily chart represents the range of prices during one day. Its vertical line connects the high and the low points of that day, while the tick on the left shows the opening price and the tick on the right the closing price. On a candlestick chart the area between the opening and closing prices is thick. Candles are hollow if prices close above the opening price or filled if they close below the opening price.

I use bar charts because that’s how I learned to trade, before candlesticks appeared in the US. Keeping an eye on the opening and closing ticks gives me the same information as candles, and I can fit more bars than candles on a computer screen. Even though this book uses bar charts, all of its techniques can be used with candles.

To create a daily bar chart using StockCharts.com, follow these steps:

- 1.) Log into your account.
- 2.) Type a ticker symbol into the “Create a Chart” box at the top of the page. We’re going to use AMZN for this example. Press the “Go” button when you are done.
- 3.) You should now be looking at a chart of AMZN with your “Default” chart settings. To see a plain bar chart, click on the “ChartStyles” dropdown located below the chart and select “Plain OHLC Bars” from the choices

A bar on a weekly chart reflects price action for one week, on a monthly chart for one month, on an hourly chart for one hour, and so on. Markets move at the same time in different timeframes, but sometimes they trend in opposite directions. For example, the trend may be rising on the

weekly chart but falling on the daily, challenging us to decide which one to follow. We'll deal with that in a moment, but please keep in mind that for a truly stereo vision of any stock you must monitor it in more than one timeframe. Those who track a single timeframe miss important information.

To change your chart to a different bar period, click on the "Period" dropdown, located above the left corner of the chart, then select the new period that you want to see (e.g., weekly, 1 hour, 5 min, etc.). Then click the "Update" button.

The key principle of using multiple timeframes is to make your strategic decision – to be a bull or a bear – on a longer-term chart, then switch to a shorter-term chart for making tactical decisions where to buy and sell. If the longer-term chart isn't clear, don't even bother going to the shorter-term chart but move on to the next stock. We should look for trades only when the strategic direction is clear.

Select two timeframes that relate to one another by approximately a factor of five. A weekly and a daily chart make a good pair. Other good pairs are monthly and weekly for very long-term trading or daily and hourly for shorter-term trading. The same approximate ratio applies to intraday charts, such as 30- and 5-minute. Watching at least two timeframes is like looking at the road ahead with both eyes. You wouldn't want to drive with one eye closed. Let your competitors do that, using only one timeframe.

Having selected a weekly and a daily pair, we'll make our strategic decisions to buy, sell short, or stand aside on the weekly chart. We'll fine-tune and implement those decisions on the daily chart.

What trading vehicles shall we chart? Let's begin with the key indexes – the Dow, the Nasdaq, and the S&P. If you live and trade outside the US, track the key stock index or indexes for your country – for example the Toronto Stock Exchange index in Canada or All-Ordinaries in Australia. Select a handful of popular, high-volume stocks to which you can give your undivided attention. It's better to update and review five charts every day than 20 charts once in a while. Be extremely cautious using ETFs, most of which poorly track their underlying

vehicles. Avoid leveraged ETFs and volatility ETFs, which a respected colleague called “as great a wealth-destroying machine as I’ve ever seen.” There is an in-depth review of six groups of trading vehicles, including stocks and ETFs in *The New Trading for a Living*.



Figure 08. AMZN weekly

Clicking on any chart in this book will take you to the same chart at www.StockCharts.com (you need to be online to use this function). You’ll be able to see that chart in a larger format, as well as view and modify its settings.

Let’s take a look at two charts of Amazon.com – a weekly chart (above) and a daily chart (below). Both are naked, without any technical indicators. Plain charting, the original approach to technical analysis, has several pluses but even more minuses. On the one hand, charts reflect everybody’s actions in any given market. On the other hand, trying to analyze a naked chart tends to be very subjective.

Old market books are filled with descriptions of heads-and-shoulders, rectangles, triangles, etc. The longer you squint at a chart, the more of them will seem to appear. If you feel bullish, you’ll keep ‘finding’ patterns that point up, and if you’re bearish, you’ll be ‘seeing’ the ones pointing down.

Just think of trendlines. You can draw them across the extreme price points or across the edges of congestion zones, which will change their angles and trading messages. Their angles will also change if you change your price scale.

Horizontal price levels make sense because traders have memories. They remember at what price levels trends reversed in the past. Masses of people buy and sell at those levels. Keep in mind that support and resistance aren't rigid like a wall of plate glass; they are flexible, like a wire fence on a farm. This is why false breakouts – quick excursion beyond the lines of support and resistance that fail to continue – provide valuable trading signals, called false breakouts.

I believe that the market doesn't know diagonals. Among the very few chart patterns that make logical sense are horizontal lines (support and resistance) and their breakouts, especially false breakouts.

Take a look at the weekly chart of AMZN in Figure 8. At the bar marked "A" the stock reached a high of \$405.63 and stalled. A few weeks later AMZN rose to \$406.69 – a negligible upside breakout – choked up and retreated. Two weeks later it opened at \$403, ran up to \$408.06, reversed, and closed at \$387.27 – below the breakout line as well as the psychologically important \$400 level. This false upside breakout led to a vicious decline.

A few months later we see a mirror image of this pattern. At bar C the stock dropped to a low of \$284.38 and then rallied. In area D it dipped to \$284, slightly below the level of the previous bottom. Recoiling from that low left behind a false downside breakout, setting up the stage for a frisky rally.

All traders watch support and resistance, but professionals and amateurs react to them differently. Amateurs love following breakouts, while the pros, who expect most breakouts to fail, like to fade them – trade against them.



Figure 09. AMZN daily

Turning to the daily chart of AMZN, we immediately notice two severe breaks, marked E-1 and E-2. Imagine buying a few days earlier and then waking up to discover that your wonderful \$360 stock has become a \$315 stock overnight. Ouch!

Both breaks were caused by earnings reports that missed Wall Street's expectations. A cautious trader doesn't get caught in such breaks. The dates of earnings reports are announced far in advance, allowing you to exit those trades. Holding a trade through earnings turns it into a crashshoot. Depending on the report, you may win, lose or stay unchanged – but that is no longer a trade but a gamble.

On the weekly chart of AMZN, we see an upside reversal near the right edge, suggesting the strategy of going long (buying). The daily chart shows a pattern of alternating rallies and declines. Rather than buying into the rally at the right edge, we may want to wait for the next minor decline on the daily chart – a wave that goes against the tide – and buy at a discount. We can sharpen this approach by using technical indicators which we'll review in the following chapters.

[Return to the top](#)

Dressing a naked chart: a pair of moving averages

Computerized technical analysis is more objective than classical charting. When an indicator is up, it's up, and when it's down, it's down. There's no fiddling with the angle of a ruler.

Technical analysis software contains a wealth of indicators, but you aren't going to use all of them. Compare this to sitting down in a restaurant and picking up a menu. You're not going to order every item on the list, only select an appetizer, a main course, and a dessert. In trading, we need to select just a handful of indicators and learn to use them.

A perfect indicator doesn't exist. Markets are complex; you cannot win using a single tool. Some indicators work best during trends, others in trading ranges. Trends and ranges are easy to recognize in the middle of a chart, but the closer we get to the right edge, the foggier they become. That's why we need to combine trend-following indicators, which are good for trends, with oscillators, which work better in trading ranges. Let's begin by selecting several indicators, and in later chapters we'll combine them into trading systems.

In selecting indicators, you may begin using what I show you here but please feel perfectly free to choose others. Just remember to keep their number down to five or, at a maximum six. That's more than enough; using more will only create confusion. I call this approach 'Five bullets to a clip.'

The first tool I like to add to every chart is a pair of moving averages.

Before using any indicator we must understand how it is constructed and what it measures.

Each tick on your computer screen reflects a transaction between a buyer and a seller – a momentary consensus of value. Buyers bid low, sellers ask for more, but they feel pressure to act before some undecided trader steps in and snatches away that deal. When a buyer and a seller step forward from the crowd and trade with each other, a price tick appears on your screen. The consensus of value it represents keeps changing with every new tick, and those ticks

coalesce into bars or candles.

Moving averages add up prices during a selected time window and average them out. If each tick is a snapshot of value, then a moving average is a composite photograph of value, a trend-following indicator.



Figure 10. AMZN daily, 26- and 13-bar EMAs

I highly recommend using exponential moving averages (EMAs) rather than simple ones. EMAs are more sensitive to changes but they don't react to the dropping off of old prices like simple averages.

The main message of any EMA is the direction of its slope. It rises when the crowd trading a stock grows more optimistic – bullish. It declines when that crowd grows more pessimistic – bearish.

A fast EMA (which I like coloring red on my chart) reflects a shorter-term consensus of value. A slow EMA (colored gold) reflects a longer-term consensus of value. I always use a pair of EMAs, with the time window of the slow EMA twice as long as the fast EMA. My pairs may be 13 and 26 or 11 and 22 bars, etc. The bars can be weekly, daily or intraday.

To add these two EMAs to your chart, follow these steps:

- 1.) Find the “Overlays” area located below the chart
- 2.) Select “Exp. Moving Avg” from one of the overlay dropdowns in that section. We’ll create the gold, 26-period EMA line first.
- 3.) Change the corresponding “Parameter” setting from the default (20) to “26”
- 4.) Change the corresponding “Style” setting from “Auto” to “Solid (Thick)”
- 5.) Change the corresponding “Color” setting from “Auto” to “Gold”
- 6.) Now, on the next line, select “Exp. Moving Avg” again from the overlay dropdown
- 7.) Change the “Parameter” from 20 to “13”
- 8.) Set the “Style” to “Solid (Thin)” and then set the color to “Red”
- 9.) Press the “Update” button



Figure 11. DDD daily, 26- and 13-bar EMAs

The zone between the two EMAs is extremely important – I call it **THE VALUE ZONE**. A swing trader aims to buy below value and sell above it – or sell short above and cover below value.

Stocks go down twice as fast as they rise. Professional traders love shorting – betting on price declines. Here you see a bearish trend in 3D Systems, Inc. (DDD), identified by the downsloping EMAs.

The bar marked “K” shows a pattern called a “**KANGAROO TAIL**” – an extremely tall bar protruding from a tight weave of prices, which typically augurs in trend reversals. The slow (gold-colored) EMA turns down, indicating a downtrend. While the value of this stock is being destroyed, DDD keeps rallying into its value zone in areas marked “Pb” for pullbacks. They provide excellent shorting opportunities for savvy traders.

Bullish traders do the opposite. When a rising slow moving average identifies an uptrend, they buy pullbacks into the value zone.

[Return to the top](#)

Profits from manic-depression (using envelopes)

Warren Buffett, perhaps the greatest living investor, says that whenever you buy a stock, you become a partner with a manic-depressive fellow he calls Mr. Market. That fellow runs up to you every day, offering to sell you his shares or to buy you out. Most of the time you should ignore him because he is crazy, but there are two exceptions.

First, when Mr. Market becomes depressed, he may offer to sell you his shares for a song, and that’s when you should buy. Second, when Mr. Market becomes manic, he may offer you a crazy price for your shares – and that’s when you should sell. These prescriptions are logical but hard to follow because Mr. Market’s mood is very infectious. Most people want to buy when he is manic (near the top) and sell when he is depressed (near the bottom).

We need to diagnose Mr. Market’s condition and instead of becoming infected by it do the exact opposite – buy when he is depressed and sell when he is manic.

The tool that will help us do that is an envelope or a channel. It consists of two lines parallel to a moving average – one line above and the other below. A well-drawn channel contains approximately 95% of prices for the past 100 bars. What’s inside a channel is normal, what’s above is mania and what’s below is depression. Channels help us recognize Mr. Market’s extremes – and trade against them.

Remember that a channel is a tool, not a complete trading system. Prices dipping below their channel shouldn't be taken as an automatic buy signal, and prices rising above it shouldn't be taken as an automatic sell signal. We'll use several technical indicators, including EMAs and channels, as building blocks from which we'll construct trading systems in later chapters.

There are several methods of building channels. The most basic and straightforward is to draw two lines parallel to a slow EMA. For example, if you use a pair that consists of a 13-day and a 26-day EMA, build the channel around the 26-day EMA. If at the right edge of the screen your EMA stands at \$100 and you decide to use a 5% channel, the upper channel line will be at \$105 and the lower at \$95.

Such channels are fine if you track a very small number of stocks because you can easily find the proper percentage for every stock. Some stocks require wider channels than others. Channels on the weekly chart have to be twice as wide as the daily channels. Because of these complexities, traders look for channels that automatically adjust their width to the volatility of any stock or index.



Figure 12. AMZN daily, 26- and 13-bar EMAs, Keltner channel (26, 2.7, 26).

Keltner channels fit the bill. They are based on the concept of Average True Range (ATR), a sensitive measure of any stock's volatility. When a stock approaches its upper Keltner channel, it's overbought: Mr. Market is manic, and we should avoid buying, no matter how tempting it feels. On the contrary, consider taking profits on long positions and look for shorting opportunities. When a stock sinks towards its lower Keltner channel, it is oversold: Mr. Market is depressed, and we should avoid shorting. On the contrary, consider taking profits on short positions and look for buying opportunities.

To add Keltner Channels to your chart, follow these steps:

- 1.) Find the "Overlays" area below the chart
- 2.) Click on the empty overlay dropdown box in that area and select "Keltner Channels" from the dropdown
- 3.) Type "26,2.7,26" into the "Parameters" box, replacing the default settings (Note: That is "twenty-six comma two point seven comma twenty-six")
- 4.) Select "Dashed" from the "Style" dropdown
- 5.) Click the "Update" button



Figure 13. AMZN daily, 26- and 13-bar EMAs, triple Keltner channels at +/- 1, 2, and 3 ATR.

My partner in SpikeTrade.com Kerry Lovvorn likes to plot not one but three ATR channels on his charts. It is normal for prices to oscillate within +/- one ATR. They go to +/- two ATRs during healthy rallies and declines, but any move outside of +/- three ATRs tends to be unsustainable. There is an article on using Keltner channels, including Kerry's method, in the

free ChartSchool at StockCharts.com. Just enter “Keltner Channels” into the “Search” box on the right-side of the StockCharts homepage to find it.

A popular volatility-based channel is called Bollinger Bands – but popular doesn’t always mean the best. Bollinger Bands’ volatility makes them useful for options traders because prices of options are driven by volatility. Stock, index and futures traders are better off using more sedate Keltner channels.

[Return to the top](#)

The power of bulls and bears (MACD indicator)

Our indicators should be simple and robust. Simple because they track only a few basic numbers: opening, high, low and closing prices, plus volume. It doesn’t pay to overcomplicate your analysis. Brian Monieson, a professional trader in Chicago, once said: “I have a PhD in mathematics, I specialized in cybernetics, but I was able to overcome those disadvantages and make money.” Good indicators are not only simple but also robust, meaning that small changes of their parameters don’t change their bullish or bearish messages.

MACD stands for Moving Average Convergence-Divergence. We can plot it as two lines or a histogram. You can study MACD in the StockCharts’ free ChartSchool as well as in all of my books.

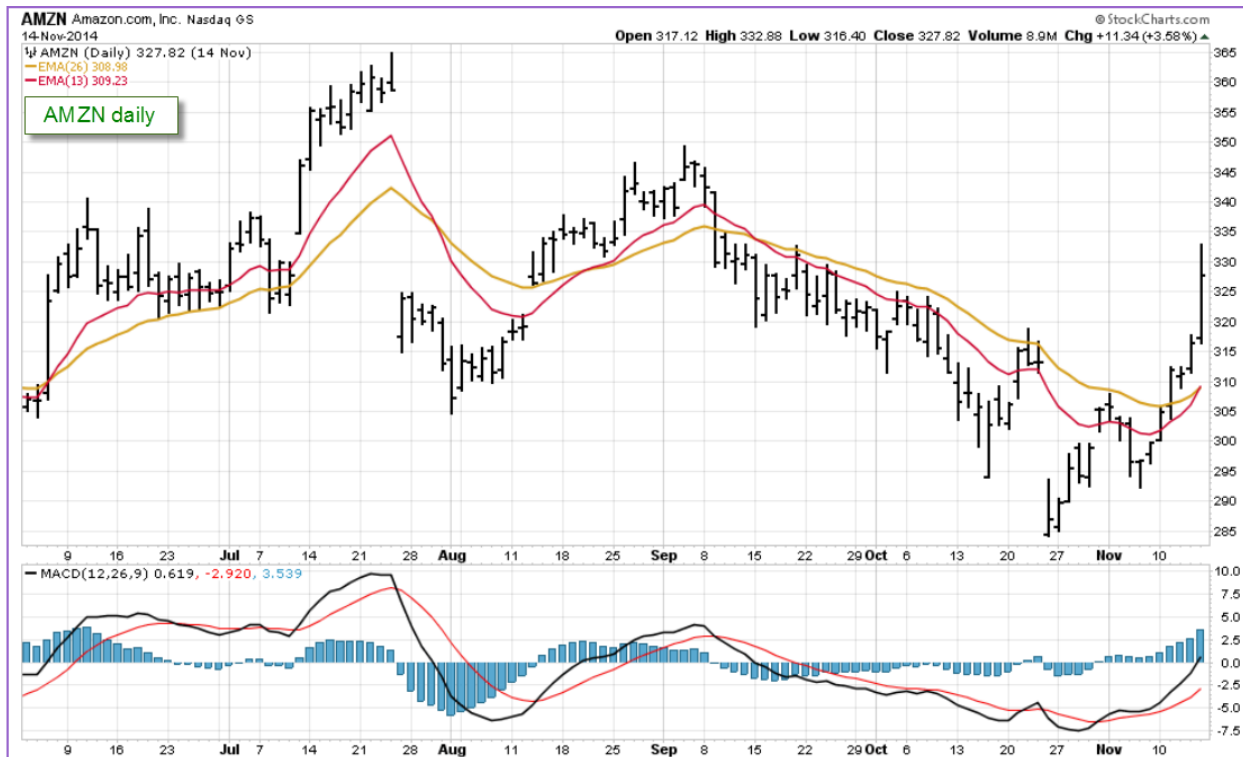


Figure 14. AMZN daily, 26- and 13-bar EMAs, MACD Lines and MACD-Histogram (12, 26, 9).

To add the MACD Indicator to your chart,

- 1.) Find the “Indicators” area below the chart. (It’s below the “Overlays” area we’ve been working with.)
- 2.) Click on one of the Indicator dropdowns and select “MACD” from the list that appears.
- 3.) Make sure that the “Position” dropdown is set to “Below” ensuring that the MACD panel appears below the price bars.
- 4.) Click the “Update” button.

The original indicator, invented by Gerald Appel, was MACD Lines. The Fast line of MACD tracks a short-term consensus of value, while the Slow line tracks long-term consensus of value. In pre-computer days Appel calculated them by hand and used their crossovers as buy and sell signals. Waiting for MACD Lines to cross leads to missing the most dynamic early part of a trend; by the time those lines intersect, half of the price move is history.

When personal computers became available, a team of programmers working under Tim Slater in New Orleans developed MACD-Histogram for tracing the spread between the two MACD Lines. It is a much more sensitive indicator of the power of bulls or bears.

MACD-Histogram shows whether bulls or bears dominate the latest price bar. If that bar is higher or less deep than the previous bar, bulls are in charge. If the latest bar is deeper or less high than the previous bar, bears are in charge. Take a look at the right edge of Figure 14, and the last two bars of MACD-Histogram clearly show which group is in charge. These are ordinary signals; the best signals of MACD-Histogram, however, are divergences.

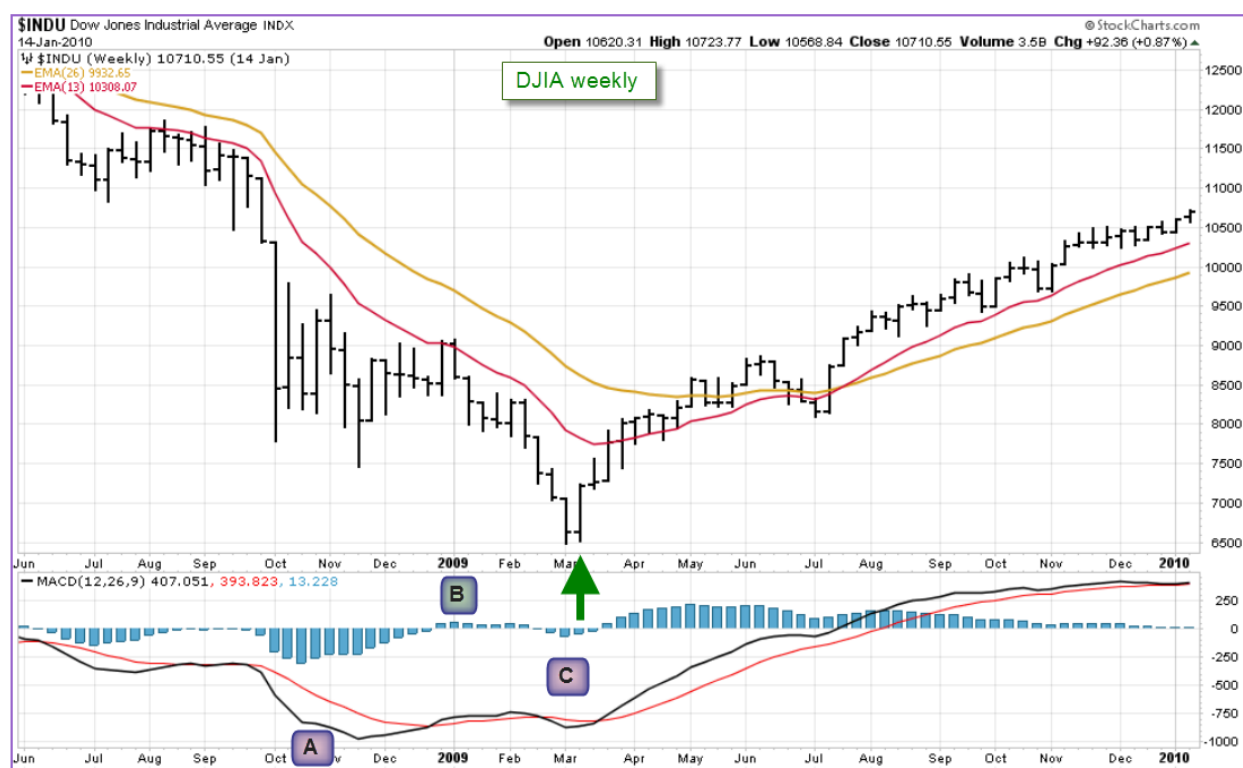


Figure 15. DJIA weekly, 26- and 13-bar EMAs, MACD Lines and MACD-Histogram(12, 26, 9)

Here's the definition of a bullish divergence: "It occurs when prices trace a bottom, rally, and then sink to a new low. At the same time, MACD-Histogram traces a different pattern. When it rallies from its first bottom, that rally lifts it above the zero line, 'breaking the back of the bear.' When prices sink to a new low, MACD-Histogram declines to a shallower bottom. At that point, prices are lower, but the bottom of MACD-Histogram is higher, showing that bears are weaker and the downtrend is ready for a reversal. MACD-Histogram gives a buy signal when it ticks up from its second bottom" (from my *Two Roads Diverged: Trading Divergences*).

The weekly chart of the Dow in Figure 15 helped me catch the bottom of the 2007-2009 bear

market. Bears slammed the market down in area A, but had their back broken when MACD-H rallied above zero in area B. Prices fell to a new low in area C, but the shallowness of MACD-H showed that bears were exhausted. When MACD-Histogram ticked up in area C, it completed a bullish divergence. That buy signal occurred during the first week of a new bull market.

Notice that breaking of the centerline between two indicator bottoms is a must for a true divergence. MACD-Histogram has to cross above the zero line before sinking to its second bottom. If there is no crossover, there is no divergence.

Another key point: MACD-Histogram gives a buy signal when it ticks up from the second bottom. There is no need to wait until it crosses above the centerline for the second time. The buy signal occurs when MACD-Histogram, still below zero, stops declining and traces out a bar that is less negative than its preceding bar.

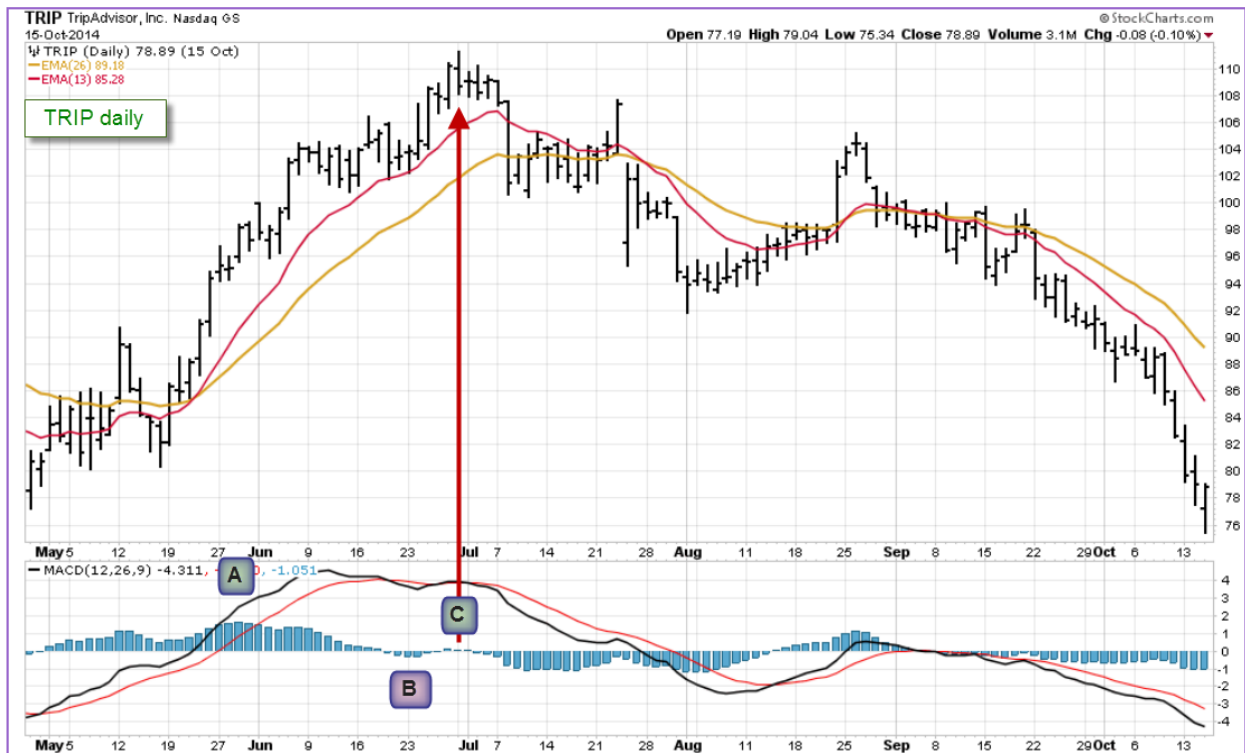


Figure 16. TRIP daily, 26- and 13-bar EMAs, MACD Lines and MACD-Histogram (12, 26, 9).

To quote again from *Two Roads Diverged*: “Bearish divergences occur near market tops, where

they identify dangerous cracks in seemingly happy uptrends. A bearish divergence occurs when prices rise to a new high, decline, then rise to a higher peak. MACD-Histogram gives the first sign of trouble when it breaks below its zero line during the decline from its first peak. When prices reach a higher high, MACD-Histogram rises to a much lower high. It shows that bulls are weaker, prices are rising simply out of inertia and are ready to reverse.”

Tripadvisor (TRIP) is a prominent company of ‘the new economy.’ I like its website, use it when I travel, and monitor its stock. In 2014 it capped its wild rally with a bearish divergence which warned of a coming downturn. MACD-Histogram rallied to a new high in area “A”, broke the back of the bull in area “B”, and delivered a feeble rally, smaller than “A” in area “C”, even as prices rallied here. The downtick of MACD-Histogram in area “C” completed a bearish divergence and sent a signal to sell and sell short. It gave a very timely signal to sell and sell short before a vicious decline.

Remember: MACD-Histogram has to re-cross its zero line between the two tops and then tick down from its second, lower peak. No matter how tempted you may feel to sell short, sit on your hands until MACD-Histogram has given you its signal. Patience is essential for successful trading. Don’t let the excitement of the game cloud your mind and jump in prematurely.

Later in this book we’ll return to MACD when we discuss the Impulse system. I will also show you one of my favorite trading methods which I call FB+BD – a combination of a false breakout (discussed in a previous chapter) with a bullish or bearish divergence.

[Return to the top](#)

May the force be with you (Force Index)

You’ve seen earlier in this book that each tick on a chart reflects a transaction between two persons: a buyer and a seller (in case of automatic trading one or both of them may have been a computer program). The buyer believes that the stock is undervalued and will go up. Had he thought otherwise, he would’ve waited to buy it lower. The seller believes the stock is overvalued and about to drop – otherwise he would’ve waited to sell it higher. Each of them

thinks he is right, but only one will make money, while the other will lose.

Rising volume reflects a greater degree of conviction among both winners and losers. As long as losers believe they're right, the trend that's impaling them can continue. Joe Granville, the late great market analyst who did some of the pioneering work on volume, used to say: "Volume is the steam that makes the choo-choo go."

Most people plot volume as vertical bars underneath price bars or candles. I prefer to track volume using an indicator that I developed: Force Index. Here is its formula for the daily charts:

$\text{FORCE INDEX} = (\text{Close of today minus close of yesterday}) \text{ times volume of today.}$

Force Index multiplies today's price change by the volume it took to accomplish that change. It can be positive or negative, depending on whether today's close was higher or lower than yesterday's. The greater price change and the greater the volume, the greater the Force Index.

We need to smooth Force Index with a moving average. A 2-day EMA of Force Index helps catch short-term swings, while a 13-day EMA of Force Index helps identify intermediate-term tops and bottoms.



Figure 17. TRIP daily, 26- and 13-bar EMAs, 2-day Force Index.

A 2-day EMA of Force Index helps identify trade entry points. Once you've made a decision to buy during an uptrend, a decline of the 2-day EMA of Force Index below zero identifies a bargain area. Once you decide to sell short during a downtrend, a rise of the 2-day EMA of Force Index above zero marks a short-term overvalued condition, a shorting opportunity. On the chart above we use the slope of the slow moving average to identify the trend. Green horizontal bars mark the areas where 26-bar EMA rises and pink horizontal bars where it declines.

To add the 2-day Force Index to your chart,

- 1.) Find the "Indicators" area below the chart.
- 2.) Click on one of the Indicator dropdowns and select "Force Index"
- 3.) Change the "Parameter" setting from "13" to "2"
- 4.) Click the "Update" button

It pays to look for divergences between the Force Index peaks and bottoms and prices. A bullish divergence is marked on the chart above with a diagonal green arrow. Divergences between the

rising bottoms of the Force Index and price bottoms show us when bears are losing power. They alert us to buying opportunities.

Watch out for downspikes of Force index, such as the one on the left side of the green arrow. Whenever the 2-day EMA of Force Index spikes down five times or more its usual depth and then recoils from that low, expect prices to rally in the coming days. Keep in mind that while downspikes often lead to upside reversals, upspikes don't provide shorting signals.

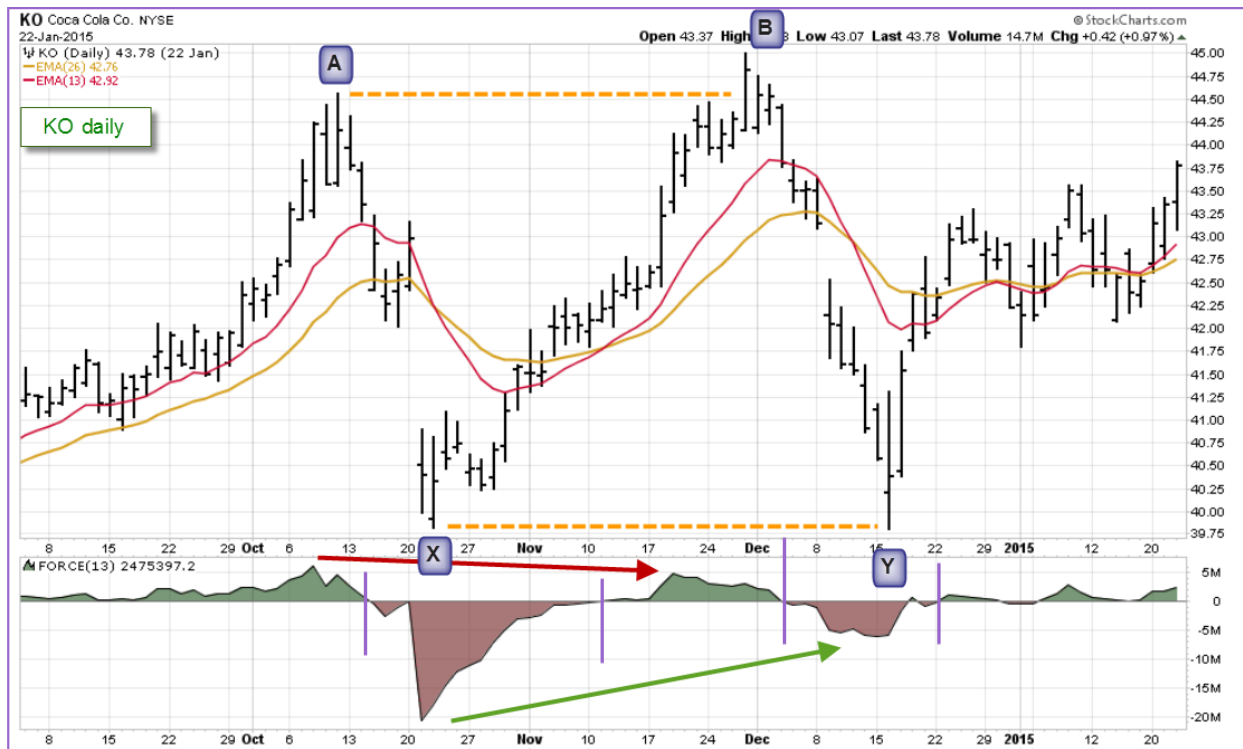


Figure 18. KO daily, 26- and 13-bar EMAs, 13-day Force Index.

A 13-day EMA of Force Index helps track longer-term balance of power between bulls and bears. When it crosses above its centerline, it shows that bulls are in control and suggests trading from the long side. When it turns negative, it shows that bears are in control and suggests trading from the short side.

To add the 13-day Force Index to your chart,

- 1.) Find the “Indicators” area below the chart.
- 2.) Click on one of the Indicator dropdowns and select “Force Index”
- 3.) Click the “Update” button

Divergences between a 13-day EMA of Force Index and prices identify important turning points, and we see two of them in Figure 18. The top B is higher than the top A, but Force Index is lower, showing that bulls have become weaker – it is a bearish divergence. Notice “breaking the back of the bull” between the two tops of Force Index, a necessary condition of a true divergence.

There is a bullish divergence between the bottoms X and Y. Prices are slightly lower at the second bottom, but the bottom of the Force Index is shallower; a rally between those bottoms “broke the back of the bear.”

Notice also a false upside breakout in area B and a false downside breakout in area Y. When independent technical signals, such as divergences and false breakouts occur together, they reinforce each other’s messages.

Experienced traders wait until a clear pattern reaches out to them from the screen and “grabs them by the face.” Don’t settle for questionable or foggy patterns. You get paid for trading well, not for trading often. Keep scanning your stocks and trade only when the picture you see at the right edge is near perfect.

Force Index spikes work quite differently on the charts of the 13-bar Force Index. Here they provide tremendously useful signals – but only on the weekly charts where they help catch trend reversals. This idea came from Kerry Lovvorn, my partner in SpikeTrade.com who added a 3-ATR channel to the Force Index. The signals we’re about to discuss don’t mark every reversal – but the ones they catch are worth trading.

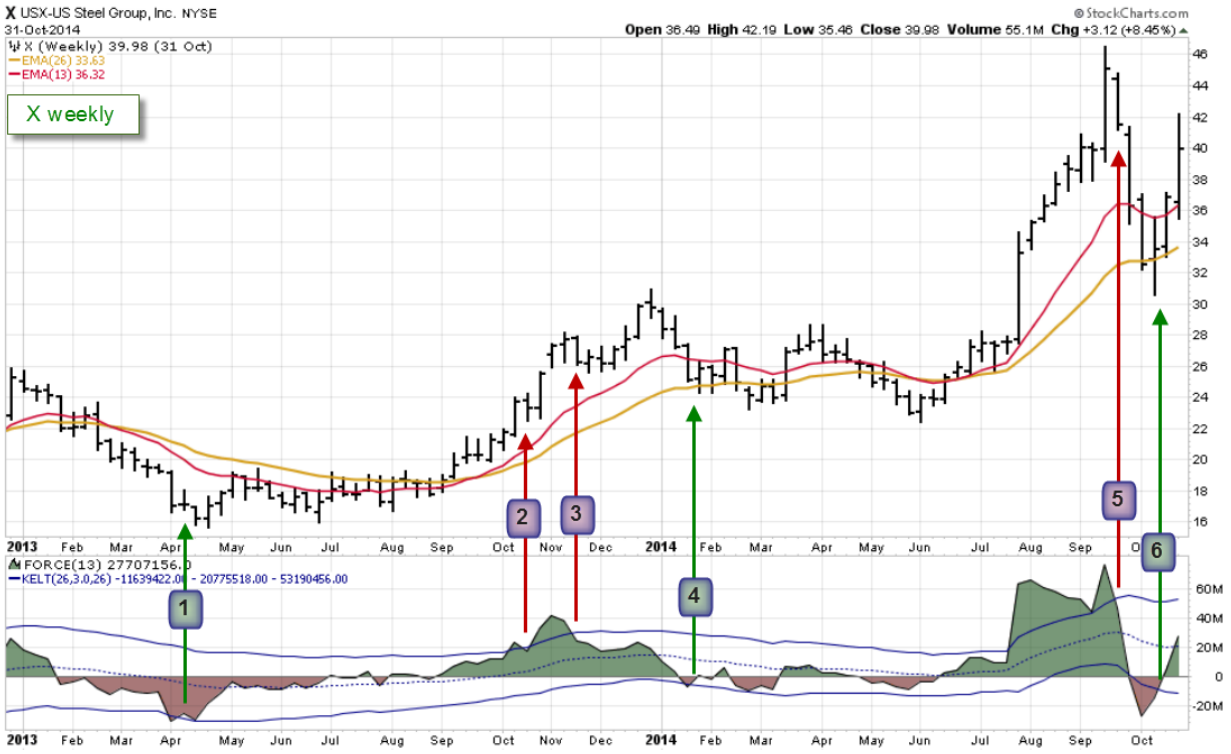


Figure 19. X weekly, 26- and 13-bar EMAs, 13-day Force Index with a 3-ATR Keltner channel.

When the 13-week Force Index escapes either above or below its 3-ATR Keltner channel, it marks a stampede by either bulls or bears. It takes an uncommonly strong burst of optimism to raise the 13-week Force Index above its 3-ATR channel. It takes an unusually powerful wave of fear to push this indicator below its 3-ATR channel. The crowd can't sustain those moves for long. When they start choking up and the 13-week Force Index returns into its channel, it shows that prices are ready to reverse and retrace at least a part of their previous move.

Arrows 1, 4, and 6 on the weekly chart above show where bears ran out of steam and gave buy signals; each was good for several weeks. Arrows 2, 3, and 5 show where bulls began to choke up and gave signals to sell and sell short. Only one signal out of six (arrow 2) didn't work out. There are no perfect signals in market analysis, which is why we must use protective stops. How to set them is described later in this book.

To add Keltner Channels to your Force Index, follow these steps:

- 1.) Scroll down to the “Indicators” area below the chart and find the line with your Force Index settings.
- 2.) Find the “Overlay” dropdown located on the far right of that same line. (See the screenshot below for help.)
- 3.) Select “Keltner Channels” from that dropdown
- 4.) Change the corresponding “Parameters” box to “26,3,26”
- 5.) Click the “Update” button.

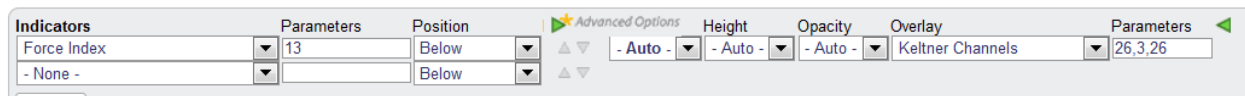


Figure 20. Adding a Keltner channel to Force Index.

[Return to the top](#)

Less is more (other indicators)

The number of technical indicators available to us is huge, but all of them are based on the same few pieces of data: open, high, low and closing prices, plus volume. This is why piling on more and more indicators doesn't improve market analysis.

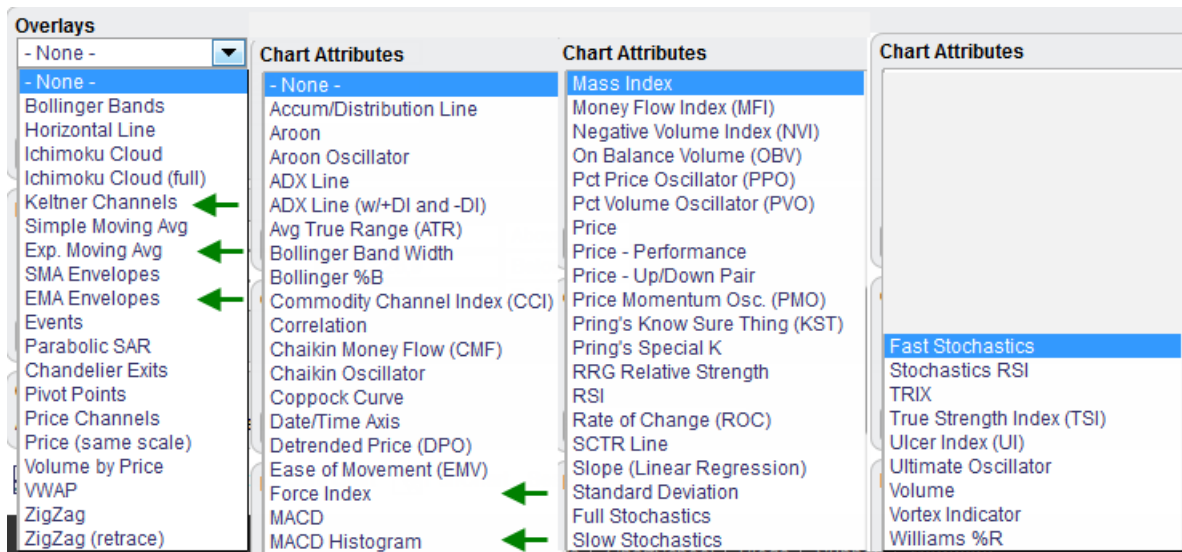


Figure 21. Indicators in StockCharts.com.

This screenshot from StockCharts.com shows its wealth of technical tools. You aren't going to use them all – just as you aren't going to eat every dish and drink every bottle of wine on the menu of a good restaurant.

The tools we reviewed in this book are marked with green arrows. You can study them in ChartSchool, a very useful section of StockCharts.com. They are described in detail in my books as well as in John Murphy's magisterial *Technical Analysis of Financial Markets*. Murphy, it must be noted, is a frequent contributor to StockCharts; his comments on intermarket analysis are original and deep.

By now we've reviewed a sufficient number to begin building trading systems. Of course, you aren't limited to the arrowed indicators. Feel free to select others if you wish but remember not to overcomplicate your analysis. Adding more and more indicators will only clutter your charts and confuse your decision-making.

I noticed long ago that as traders' performance improves, their charts become more sparse. Less is more in trading. We need to select a few indicators, understand them well, and then focus on the structure of trading systems and risk control.

“Enough” is the power word in trading as well as in life. “More!” is a recipe for an endless chase, thinking you’re missing something, feeling dissatisfied. “Enough” puts you in a position of power and control.

[Return to the top](#)

Trading Systems

The trades to avoid (the Impulse system)

Before we build a trading system let’s set up a censorship system. The Impulse system will keep us out of trouble by showing when not to trade. As Jesse Livermore, one of the great speculators of the 20th century, said to an interviewer: “There’s a time to be long, a time to be short, and a time to go fishing.”

The Impulse System applies a pair of indicators to any trading vehicle or an index: a fast exponential moving average and MACD-Histogram. The slope of the EMA reflects the direction of the market’s inertia. The slope of the last two bars of MACD-Histogram shows the direction of market power. Their combination colors every bar: green if both are rising, red if both are falling, and blue if they move in the opposite directions. When both the inertia and the power are pointing against your planned trade, you shouldn’t be getting into it. Wait until the Impulse system removes its prohibition.

The Impulse System

EMA		MACD-H	=	Impulse	Yes	No
	+		=		Buy, stand aside	Short
	+		=		Short, stand aside	Long
	+		=		Long or short	
	+		=		Long or short	

Figure 22. Colors and messages of the Impulse system [from *The New Trading for a Living*].

- * EMA rising & MACD-Histogram rising (especially below zero) = Impulse is green, bullish. Shorting is prohibited, buying or standing aside is permitted.
- * EMA falling & MACD-Histogram falling (especially above zero) = Impulse is red, bearish. Buying is prohibited, shorting or standing aside is permitted.
- * EMA rising & MACD-Histogram falling = Impulse is blue, neutral. Nothing is prohibited.
- * EMA falling & MACD-Histogram rising = Impulse is blue, neutral. Nothing is prohibited.

When both indicators decline, showing that bears are in charge, they prohibit buying. When both rise, showing that bulls are in charge, they prohibit shorting. We need to check the colors of the Impulse system in two timeframes – our favorite (tactical, usually daily chart) and the chart one order of magnitude longer (strategic, usually weekly chart). If even one of them says ‘no’ to our trade, we should stand aside and wait for the Impulse system to release us to trade.

As for the indicator parameters, we can use a 13-bar EMA and a 12-26-9 MACD-Histogram. You may change these parameters, just be sure to use the same numbers consistently.

The Impulse system doesn’t mean “buy green, sell red,” as some copy-cats cheerfully declare. By the time the Impulse system turns green, the uptrend is well under way. If you wait to buy

until the Impulse turns green, you'll miss the best opportunities. Our goal is to identify a potential buy early, while the Impulse system is still red, and then closely monitor that stock. As soon as the Impulse changes from red to blue, it removes its prohibition of buying and releases us to buy. Its best signals are given not by color (green or red), but by the disappearance of color (the Impulse stops being red or green and turns blue).

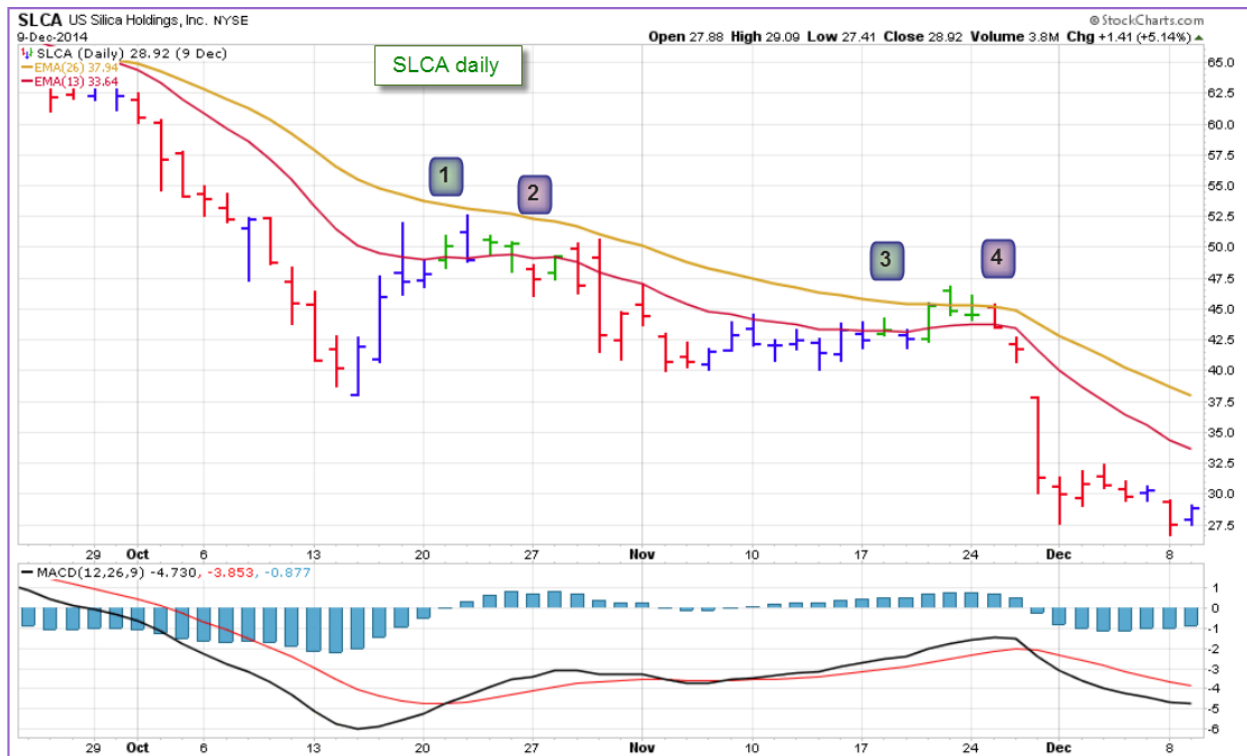


Figure 23. The Impulse system.

To change your chart into an Impulse System chart:

- 1.) Find the "Type" dropdown located in the "Chart Attributes" area underneath the chart.
- 2.) Click on the dropdown and select "Elder Impulse System" from the very bottom of the list that appears
- 3.) Press the "Update" button

Silica Holdings Inc. (SLCA) serves oil producers in the Canadian tar sands as well as frackers. It was one of the "hot" stocks of 2014 and rallied from \$24 to \$73, more than tripling in 7 months. As it began to decline, bargain-hunters started coming in. Notice how the red bars of the Impulse system kept telling buyers to leave it alone. Red bars prohibited buying. In area 1 the Impulse system went blue, then green, permitting buying, but quickly withdrew that permission

when it turned red again in area 2. Another short-lived permission to buy in area 3 was cancelled in area 4. Those messages of the Impulse system helped shorts make money (that was the side I was on), but week after week told buyers to stay away, stay out of trouble.

The Impulse System isn't a trading system – it's a censorship system. It doesn't tell you what to do – it shows what you're not allowed to do. Find your trade using whatever system you like (we will review several systems below), but take a look at the Impulse system in your favorite (intermediate) timeframe as well as in the timeframe one order of magnitude longer before placing your order. The Impulse system will tell you whether you are allowed or not allowed to make that trade. Hold off entering a trade until the Impulse System releases you to act.

[Return to the top](#)

Every trade deserves a name (the system you trade)

As you scroll through the charts of various stocks, it is essential to have a very clear image in your mind of the pattern you're looking for. Every trading system is designed to handle a specific price pattern. When you find a chart that matches that pattern, work up a possible trade.

Be sure to write a description of the system you'll trade. What kind of pattern will it look for? What kind of stock? What rules will you use for entries and exits? Write down your answers to these questions. This discipline will put you miles ahead of most competitors.

“I heard good things about it” or “it looks kinda good” aren't legitimate reasons to put on a trade. Each trade must be based on a specific system. You may have more than one system, but each trade must follow only one.

Let me list several questions that apply to every trade and suggest some answers before we turn to specific systems in the following chapters.

What class of trading vehicles will you trade? The best area for beginners is stocks. Avoid the delusion of buying options as a substitute for stocks, be super-cautious about ETFs and avoid

leveraged ETFs like the plague. Leave those for day-traders only.

Which stocks will you trade? Set your minimum daily volume in order to avoid bad slippage in thinly traded stocks. I look for those that trade over a million shares per day. Avoid penny stocks, with their huge percentage swings – set your minimum price around \$5.

Where will you look for trading ideas? Perhaps there are stock industry groups you're interested in – select the most liquid, high-volume stocks in those groups and follow them on a daily basis. Don't spread yourself too thin. The internet is brimming with stock tips, but trying to follow them is like drinking from a fire hose. Select one or two sources you trust – pay attention to them and go easy on the rest. StockCharts.com has several contributors who publish daily reports; I like piggy-backing ideas of the elite-level members of SpikeTrade.com; SeekingAlpha.com is worthwhile if you track fundamentals.

These and many other decisions are ahead of you. Don't let things happen by default. Be mindful and alert. And now, let me show you a few systems, two of which are my own and two from the traders I respect.

[Return to the top](#)

Buying pullbacks in an uptrend

It feels tempting to buy a stock that's hitting new highs, but many buyers get shaken out by pullbacks that tend to follow rallies. That's how people end up buying high and selling low.

If you identify an uptrend and then wait for a pullback, you can get your stock at a discount (and if you don't get it – forget it. There are many more fish in the sea). We can protect a pullback trade with a stop not too far away, and take profits when that stock rallies again.

If you compare a trend to a tide, a pullback is like a wave splashing against that tide.

The same approach works with selling short. Once we identify a downtrend, like a tide going

out, wait for a counter-trend rally in order to sell short. Shorting is a very worthwhile activity, popular among professionals, but not suitable for beginners because stocks drop twice as fast as they rise. Shorting demands quick reactions and good risk management skills. Learn buying first and expand into shorting later.

To implement the pullback system, we'll use two charts. We'll make our strategic decision – to be a bull, a bear, or stand aside – on the weekly chart. If that chart is bullish, we'll turn to the daily chart for tactical decisions on where to enter and place our stop and target. If the weekly chart is bearish or doubtful, let's skip the daily and move on to the weekly chart of another stock.

There is a lot of chaos in the markets and when a stock looks doubtful, skip it and move on to the next candidate. Traders with a scientific background often have a fantasy that they can identify a trend by adding more tools, but no fancy indicators will clear up a chaotic market. A promising trade has to grab you by the face. When a stock's trend is unclear, no amount of analysis will find a good trade. Don't waste your time on doubtful stocks – trade only those whose signals leap at you from the screen.

Here's what we'll be looking for:

- * The weekly slow EMA is rising.
- * The weekly Impulse system is green or blue (cannot be red).
- * On the daily chart prices are in the value zone or below it (cannot buy above it).
- * The daily Impulse system is blue (wait until it stops being red).
- * The two-day Force Index is below zero.

Trade rules:

- * Buy in the value zone on the daily chart.
- * Place a stop near the low of the second lowest recent bar or 1.5 ATRs below your entry, whichever is lower. We'll discuss ATRs in a chapter on stops.
- * Set a target at least as high above value as the purchase is below. Attractive trades have

reward-to-risk ratios better than 2:1.

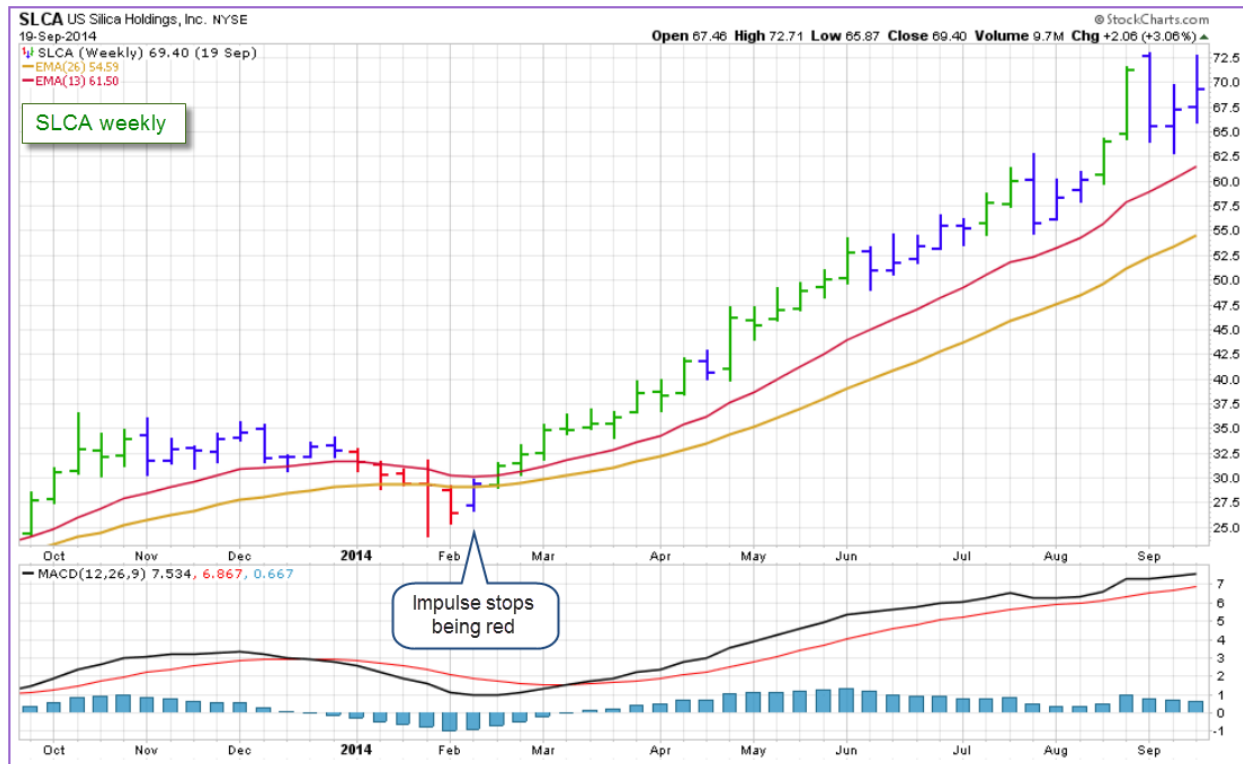


Figure 24. SLCA, the Impulse system weekly. 26- and 13-week EMAs, 12-26-9 MACD Lines and MACD-Histogram.

In 2014, Silica Holdings, Inc. (SLCA) was in the news for most of the year. The stock was in the news as a major supplier for the Canadian tar sands industry. Looking at the weekly chart, we see a steady rise, with the stock consistently above its fast and slow moving averages. The Impulse system stopped being red in February, permitting buying.

To create a weekly chart similar to Figure 24 from scratch, follow these steps:

- 1.) Type "SLCA" into the "Create a Chart" box at the top of any of our webpages and then click the "Go" button
- 2.) Find the "ChartStyles" dropdown box located just below the bottom of the chart
- 3.) Click on that dropdown to open it up, then select "Elder's Weekly Stocks" from the dropdown list.



Figure 25. SLCA, Pullback to value daily. 26- and 13-day EMAs, 3-ATR Keltner channel, 12-26-9 MACD Lines and MACD-Histogram, 2-day Force Index.

With the weekly chart clearly rising and permitting us to buy, let's turn to the daily chart for tactical decisions where to enter, set targets and place stops. Here you can see that once every five or six weeks a brief panic hits the stock. It gets pushed down into its value zone, Force Index turns negative, and the Impulse system goes red, prohibiting buying.

To convert your weekly chart into a daily chart, simply select "Daily" from the "Period" dropdown above the chart and press the "Update" button.

As soon as the red disappears, the Impulse releases us to buy that pullback to value – those bars are marked with vertical green arrows. Stops should be placed in the vicinity of the pullback lows, and profit targets near the upper channel line. Once prices rally above the upper channel

line and drop back below it, that's the last call to take profits, in the areas marked with vertical red arrows.

Some may ask: once I buy using this system, why not keep the stock for as long as the weekly trend continues to rise? Why exit at a nearby profit target?

You certainly may attempt that, but it will no longer be a swing trade. Long-term trend-following lures us with its promise of great profits, but it has its disadvantages. It is a hugely stressful challenge to hold a trade through a deep drawdown, not knowing whether the trend will continue or reverse. Deep drawdowns are likely to occur during long-term trends. Swing trading is more reliable and less stressful. We'll return to this question in a later chapter.

You learn to trade by making trades and managing them. The more often you trade and keep good records, the more you learn. Swing trading – holding trades from a few days to a few weeks – provides the sweet spot for learning to trade. Once you become a competent and confident trader, you may expand in both directions: long-term investing or day-trading.

Returning to the daily chart above, notice a very severe bearish divergence of MACD near the right edge. Additional warnings to the bulls come from a bearish divergence of Force Index as well as the fact that prices couldn't rise above their channel during the latest rally. No tree grows to the sky, and an accumulation of bearish signals sends a message to look for another stock to apply the pullback system to. Sure enough, by the time of this writing the oil crisis has hit and SLCA is back in the low 20's.

[Return to the top](#)

Catching reversals (false breakout with a divergence)

The Reversal system aims to do the opposite of the Pullback system: instead of catching trends, it's designed to trade their reversals. It looks for a different pattern than a Pullback system and takes different actions. This is why each trade needs to have the name of a specific system attached to it – to make you focus on the pattern you're aiming to catch.

In this book we'll focus on going long: catching the ends of downtrends and buying upside reversals. Let's leave catching downside reversals and selling short for a later, more advanced stage of your development.

The reversal system uses the charts of two timeframes. We begin by scanning the weeklies, looking for stocks whose declines appear to be slowing down and finding support. Stay away from sharply falling stocks – don't try to “catch a falling knife.” Look for slower declines that appear to be bottoming out. A pattern of a sharp bottom, a reflex rally, and then a slower retest of the lows may offer an attractive buying opportunity when accompanied by a bullish divergence. A good place to look for this pattern is among industry groups that are currently out of favor with the general public.

Here's what we'll be looking for:

- * The weekly chart shows a double bottom, with the second lower than the first
- * The weekly Impulse system stopped being red.
- * Either weekly or daily chart shows a bullish divergence of MACD-Histogram
- * On the daily chart prices are in or near the value zone.
- * The daily Impulse system is not red.

Trade rules:

- * Buy near the value zone on the daily chart.
- * Place a stop near the low of the second lowest recent bar or 1.5 ATRs below your entry, whichever is lower. We'll discuss ATRs in a chapter on stops.
- * Set a target near the fast EMA on the weekly chart.

In a nutshell, we'll identify our candidates on the weekly chart, then switch to the daily chart and look for a combination of two patterns:

- * A stock falls to a new low but then rallies to close above its recently broken line of support.
- * An indicator, such as MACD-Histogram, traces a bullish divergence in either timeframe.



Figure 26. AMZN, the Impulse system weekly. 26- and 13-week EMAs, 12-26-9 MACD Lines and MACD-Histogram.

This weekly chart shows a decline of AMZN which slowed down after hitting support (marked by an orange dashed line). Remember that support is not rigid – it’s more like a wire fence than a sheet of glass. Bears keep pushing weekly bars down, but cannot sink an entire bar below that line. During the bar marked with a green arrow weekly MACD-Histogram ticked up, turning the Impulse blue and permitting buying.



Figure 27. AMZN, Reversal system daily. 26- and 13-day EMAs, 3-ATR Keltner channel, 12-26-9 MACD Lines and MACD-Histogram, 2-day Force Index.

Just as the decline on the weekly chart was finding support, the daily charts showed multiple bullish divergences. There was a triple bullish divergence of MACD-Histogram and a bullish divergence of Force Index, in which the first bottom was a downspike – another bullish signal. There was also a false downside breakout at bottom 3. These signals kept coming one after another, reinforcing each other.

After catching an upside reversal and profiting from it, remain aware of continuing opportunities to follow that stock in its new uptrend. You can now switch to the Pullback system, buying in the value zone and taking profits at the upper channel line.

[Return to the top](#)

An end-of-day trend-following system (by Kerry Lovvorn)

Most of us begin by reading about other people's systems, finding one that appeals to us, and then using it. After a while most of us start tweaking our borrowed systems – until they gradually become as individual as we are. We may remember where our system had originally come from, but by now it has become our own.

Compare this to driving – whether you drive on the right or the left side of the road, or even down the middle of a dirt path in a remote area, your driving style is as personal as your signature. You obey safety rules, but the way you get from A to B reflects your style.

I think that the best place to see other people's systems is SpikeTrade.com – an online community I co-lead with my friend Kerry Lovvorn. Our members compete for the best stock pick of the week, and as they post their trades, members get to see their systems and can ask them questions.

The following system comes from the section of SpikeTrade called “Q&A with A&K.” That's where Kerry and I take turns answering members' questions.

A member from South Carolina wrote: “I don't have the time to actively manage trades and would be interested in a simple swing trend-following system that I could check at end of each day. What are some suggestions for a system if one exists.”

Kerry replied: “Many of us tend to over-complicate our approaches to the market and lose sight of its basic principles. The difficulty with any trend-following system is the word "follow." A trend follower must put aside his thoughts and opinions and follow the trend as long as it remains in force.

“Whenever I build a trading system, I start with a core concept, such as ‘for an uptrend to remain in force, prices must keep making higher lows.’ This calls for buying when a potential new

uptrend is forming and selling when that trend may be ending. The idea is to catch short-term upswings that last 10 to 20 bars and ride them as long as a stock continues making higher lows.

“Next, let’s define our parameters for buying and selling. We’ll use a variant of a moving average trend-following system, but with a twist: use an EMA of the lows rather than the usual EMA of closing prices.

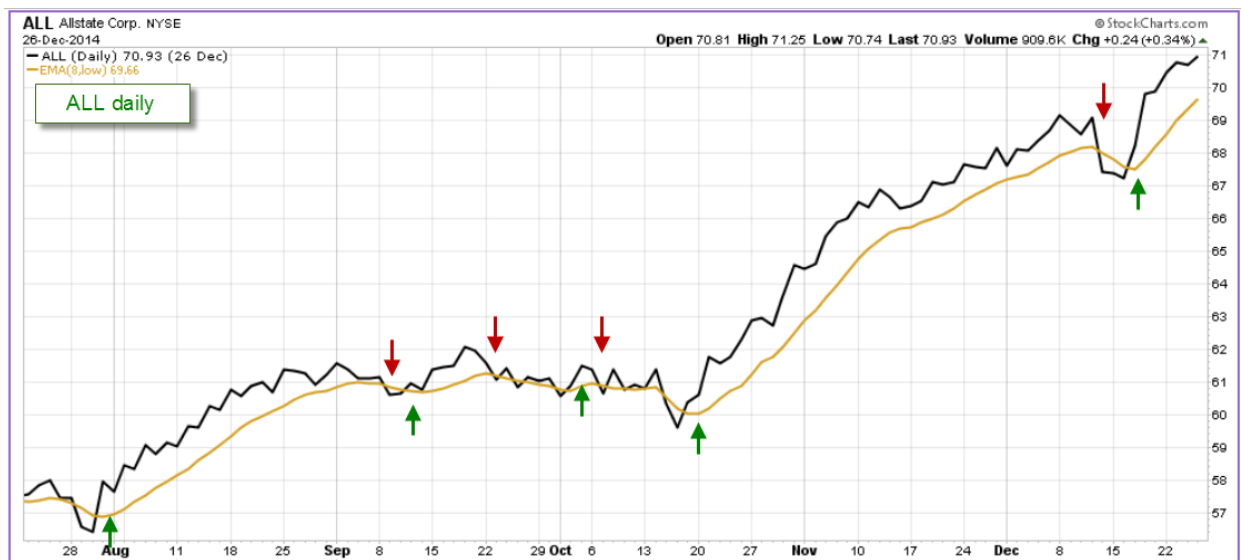


Figure 28. ALL, A Trend-following System daily. A line chart of closing prices and an 8-bar EMA of the lows.

To create the chart above, follow these steps:

- 1.) Type “ALL” into the “Create a Chart” box at the top of any of our pages and then click the “Go” button
- 2.) Find the “ChartStyles” dropdown just underneath the chart that appears
- 3.) Click on that dropdown and then select “Plain OHLC Bars” from the list that appears
- 4.) Find the “Type” dropdown located in the “Chart Attributes” area underneath the chart
- 5.) Click on that dropdown and select “Solid Line (thick)” from the list that appears
- 6.) Find the empty dropdown in the “Overlays” area located a little lower down the page
- 7.) Click on that dropdown and select “Exp. Moving Avg.” from the list that appears
- 8.) Change the “Parameters” box from the default (20) to “8,low”
- 9.) Change the “Style” from “Auto” to “Solid (thick)”
- 10.) Change the “Color” from “Auto” to “Gold”
- 11.) Click the “Update” button to see your chart

“The black line in the figure above represents closing prices, and the gold line an 8-period

average of the lows. Remember: this EMA is based on the lows of each bar instead of its closing ticks. For an uptrend to continue, prices must keep making higher lows.

“Now let's set our conditions for buying and selling. Let's buy when price has traded below its 8-bar EMA of the lows for more than two bars and then closes above that line. Let's sell when prices close below the 8-bar EMA of the lows, indicating the uptrend is in danger. We may not act until those conditions are met. Buy and sell signals are marked with green and red arrows on the chart above.

“This is a very simple setup with only two rules. We know we will make money as long as prices trend up for more than 10 to 20 bars on average. The next step is to identify suitable stocks to trade using this system. First test it on paper, then with real money, starting with a small size.

“Not all systems are kept to such bare minimums. Many of us tend to complicate our systems before we even validate their basic concept. We may be surprised just how little we need to follow a system to make money.

Hope this helps,
Kerry

PS... each person is different which is why any single system will not fit all traders. We must find a system that suits our personality and risk tolerance. If we don't match our system to the way we are wired, it would be impossible to maintain discipline. I focus on this whenever traders consult with me.”

[Return to the top](#)

Trading with fundamentals and technicals (by Philip Wu)

At the time of this writing Philip is the top-performing Spiker (an elite-level member) of SpikeTrade.com. Both trades shown below come from his “How I Won My Gold” posts. Each weekend the Spiker who wins our trading competition during the previous week posts his “Gold”

report (you can read those reports even as a non-member – they’re open to guests).

Philip selects his trades on the basis of fundamental news items that are getting a lot of play in the media. He zooms in on specific stocks using a few technical tools, and backs all his trades with ironclad risk management.



Figure 29. TKMR daily with triple ATR channels, 12-26-9 MACD Lines and MACD-Histogram and 5-day Force Index.

On October 18, 2014 Philip posted a report titled “Managing an Ebola trade with a protective stop – Long TKMR.” He wrote: “Tekmira Pharmaceuticals Corporation (TKMR) is a biopharmaceutical company focused on advancing novel therapeutics. It provides leading lipid nanoparticle delivery technology to pharmaceutical partners. Over the past weekend there was significant news coverage of the Ebola crisis. I decided to pick a drug stock in this area to

leverage on this news event which could send prices higher. Canada-based Tekmira Pharmaceuticals was said to be furthest along among the companies working on Ebola treatment. Technicals showed TKMR price as oversold, near a support level, and on a rising channel. I chose TKMR as my Spike pick.

“On Monday TKMR gapped higher, skipping over my buy limit at \$22.80. I decided to raise my buy limit to \$23.20 and was filled late in the afternoon. On Tuesday, TKMR had a relatively wide range, but closed near the opening price. On Wednesday it opened higher, and I started raising my protective stop to preserve profits. Once TKMR went 5% above my purchase price, I decided to tighten my stop very closely and was eventually stopped out at \$24.49 for a 5.56% gain.

“In summary, the news on the Ebola crisis provided a catalyst to move Ebola drug stocks higher. Due to the relatively high level of volatility, careful trade management through protective stops was needed to preserve profits. Without the protective stop, I would have ended with a 6% loss for the week, as prices fell to close at \$21.76 on Friday.”

Notice that Philip uses different Force Index parameters – he applies a 5-day moving average to smooth out Force Index, instead of the 2- or 13-day EMAs that I use. Serious traders typically like to personalize their indicators.



Figure 30. HOV daily with triple ATR channels, 12-26-9 MACD Lines and MACD-Histogram and 5-day Force Index.

On November 15, 2014 Philip posted a report titled “Managing with protective stops – Long HOV.” He wrote: “Hovnanian Enterprises (HOV) designs, constructs, markets, and sells residential homes in the United States. Over the past weekend there were several positive news articles on the recovery of the housing market due to lower energy costs and the potential relaxation to the mortgage lending process. I decided to pick a house builder stock to ride this sentiment. I chose HOV because it had been in a narrow trading range for the past 14 days, building a potential coil to spring higher.

“On Monday HOV gapped higher and opened above my buy limit at \$3.70. Since the price action was still bullish, I decided to raise my buy limit to \$3.98 and was filled at 1:30 pm. On

Tuesday HOV opened higher than the prior day's close and continued to move strongly higher. When it rallied 3% above my purchase price, I decided to begin raising my protective stops to protect profits. During this trade which lasted 2 days, I moved my protective stops five times from \$3.60 to \$3.90 to \$4.00 to \$4.10 to \$4.20, where I was eventually stopped out for a profit of 5.53%.

“In summary, the positive housing outlook provided a catalyst to move HOV higher. The price action on HOV confirmed the bullish sentiment. As HOV began to rise sharply on Monday and Tuesday, careful trade management through protective stops was needed to protect profits.”

[Return to the top](#)

Trade Management

The sweet spot (what timeframe will you trade?)

Once you become interested in buying a stock, do you ask yourself how long you intend to hold it? Minutes? Hours? Days? Weeks? Years? Forever? This is an important question because different timeframes call for different trading methods. You'll have your finger on the trigger when day-trading but may go for a week without looking at a stock in which you invest for the long term.

All trading timeframes can be divided into three broad groups: day-trading, swing trading, and long-term trading or investing. Each has its own advantages and disadvantages, but only one is especially suitable for beginning traders.

Day-trading can be profitable for the pros, but is extremely demanding, way above any beginners' abilities. Day-trading requires instant reactions: if you stop to think, you're dead. Beginners need to stop and think at every step, which puts them at a huge disadvantage in this deadly serious game. All they get out of it are losses, bruised self-esteem and the memories of a very expensive ride.

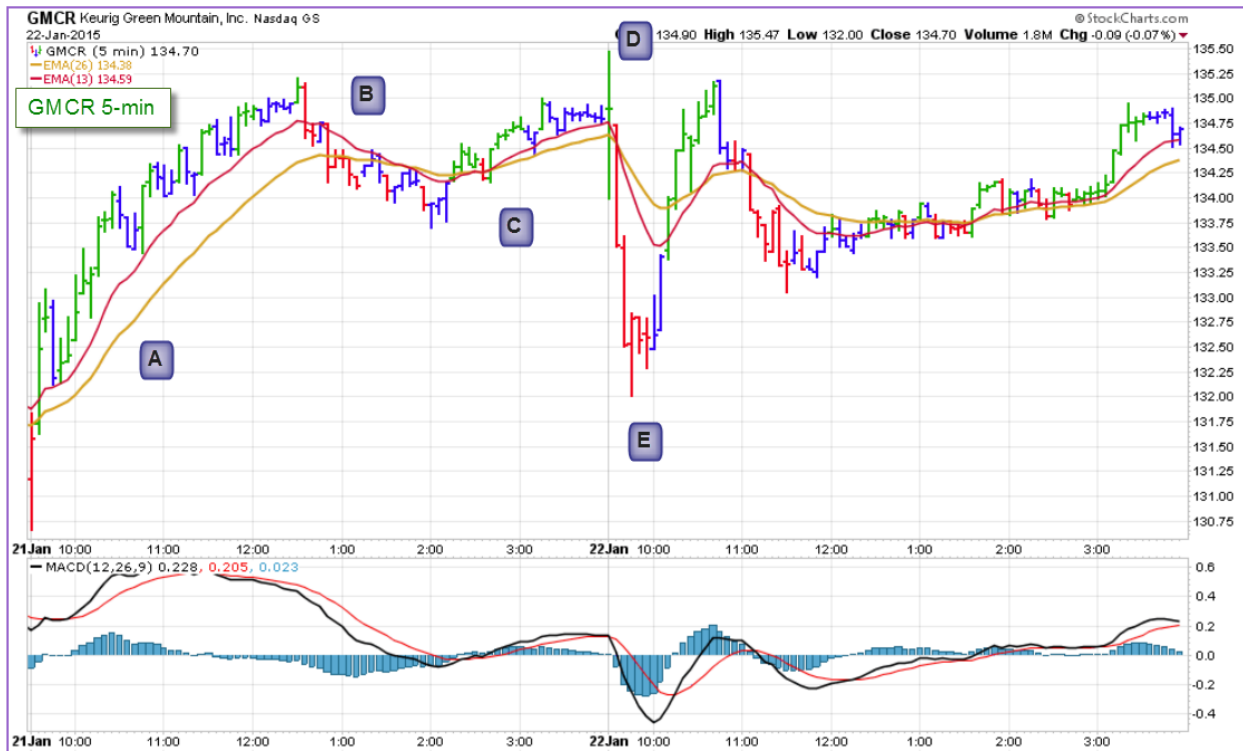


Figure 31. Day-trade. GMCR 5-minute chart with 13- and 26-bar EMAs, 12-26-9 MACD Lines and MACD-Histogram. Note: this chart cannot be clicked on because of restrictions on old intraday data.

Take a look at this chart of Keurig Green Mountain Inc. (GMCR), a popular vehicle among day-traders. It reflects two days of trading, with each bar covering 5 minutes. On day one, the stock stabbed down at the open, followed by a powerful uptrend (area A). A pullback in area B was followed by a new rally (area C) until the closing bell. That rally was hard to trade due to its very small ranges.

The next day began with a quick stab up (D), creating a false upside breakout with a bearish divergence. GMCR immediately collapsed into the area E, and then very suddenly reversed. After retracing its decline it spent the rest of the day going nowhere. There was a lot of activity, but to profit from it and to avoid losing money you'd have to be a top-level pro, operating at high speed, without any hesitation. That was definitely not a beginners' game.

I am shocked by the ads inviting beginners to day-trade. Their brokers will profit because day-

trading generates lots of commissions, but the outcome for a newbie trader will be the same as for a non-athlete attempting a high-wire walk.

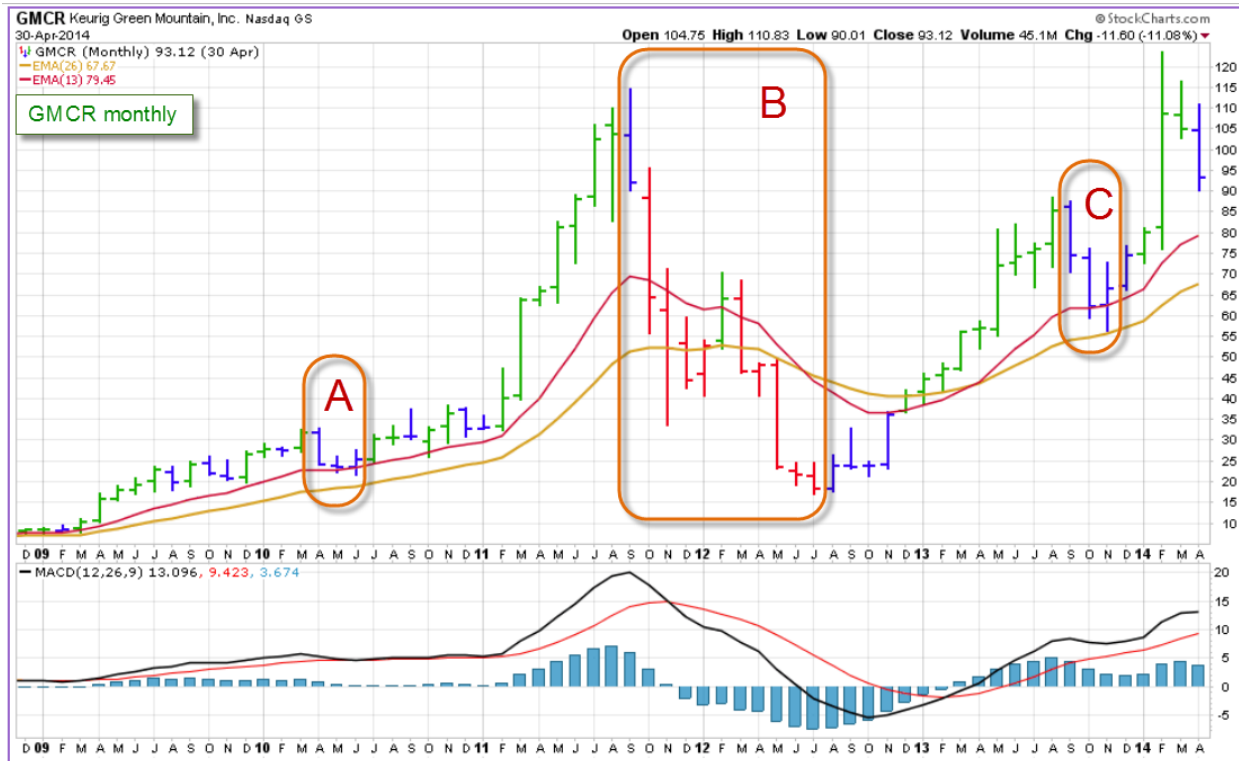


Figure 32. Investment. GMCR, monthly chart.

Position trading or investing is at the opposite extreme of time, slow as molasses. Take a look at this monthly chart of the same stock, where each bar represents one month of price action. GMCR rallied from under \$3 in 2006 to over \$150 per share. That's one delicious cup of coffee. Hey, barista, pour me another one, with sugar and cream! It looks sweet indeed – but the question is, will you be able to hold this cup in your hands without getting burned?

First of all, the rise in GMCR (and Google, and Apple, and many other leading stocks), so clear in retrospect, was anything but clear early on. There were hundreds of other young promising companies that died, went bankrupt, merged, and disappeared. Even if you had the amazing foresight to buy a thousand shares of GMCR at \$3, would you have been able to hold them through area A, where the stock dipped 33%? How about area C, where it dipped 28%? And what about area B – would you have held while the value of your shares sank 85%?

Long-term trading or investing demands a combination of brilliant foresight with an iron will. My hat's off to you, Mr. Buffett. Not too many mortals can do that.

Let's stay away from the extremes of day-trading and long-term investing. The sweet spot is in the middle. Swing trading – catching price moves that last from a few days to a few weeks – avoids the interminable wait and gut-wrenching drawdowns of investing. It also avoids having to make instant decisions in day-trading. You have the time to think about what to do with your trade – without waiting too long for the results.

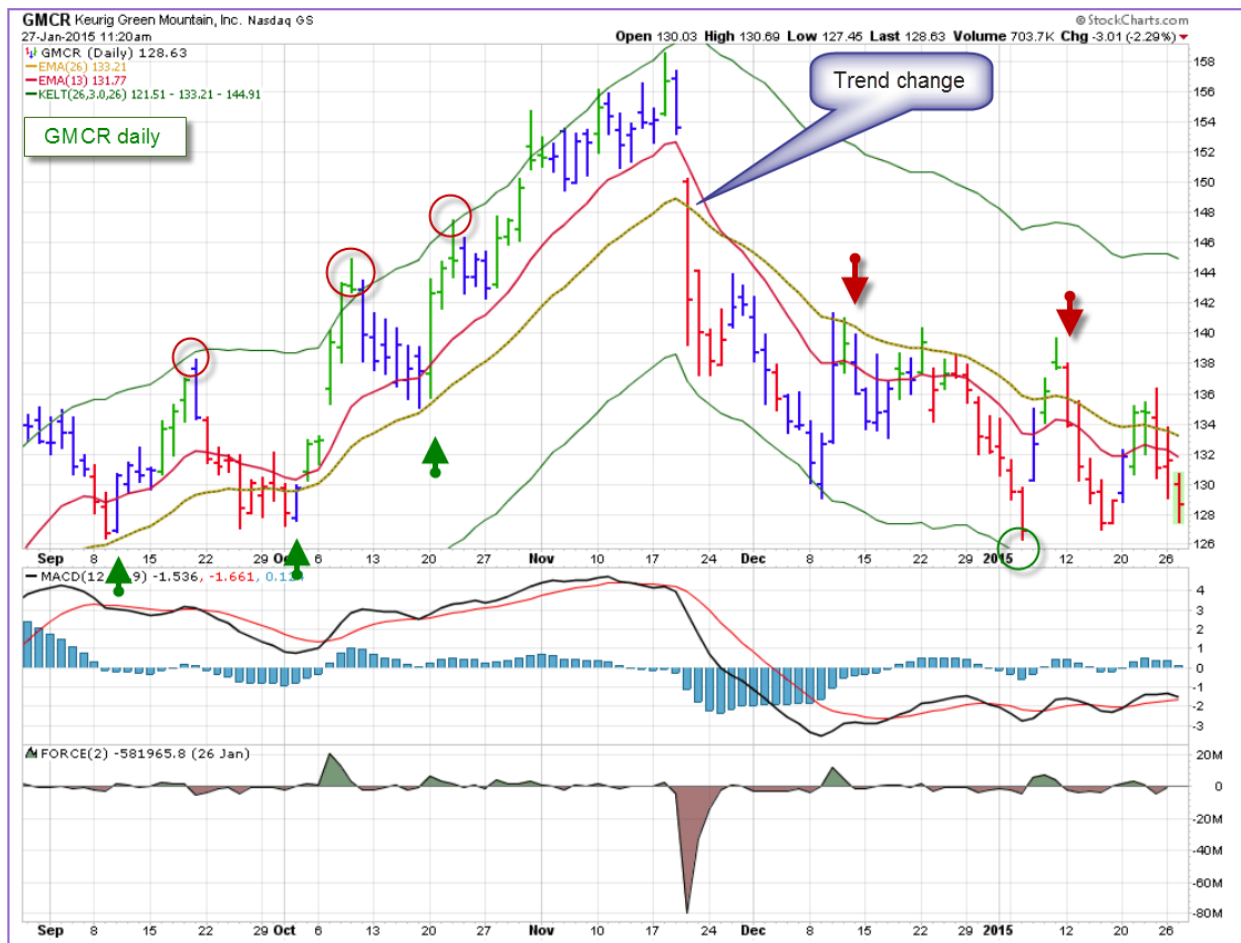


Figure 33. Trading. GMCR, daily chart.

On the daily chart of GMCR we see an uptrend, a reversal, then a downtrend. Green arrows mark the days on which prices dip down into their value zone while the Impulse stops being red,

permitting us to buy. From there the stock rallies to an overbought level near the upper channel line (circled in red), suggesting profit-taking.

After the trend turns down, a savvy trader can reverse the process – sell short in the value zone and cover in the oversold area near the lower channel line. Of course we can use a weekly chart to better define the trend and pay close attention to daily indicators.

One of the traders I interviewed for my book *Entries & Exits* said: “Some traders hunt elephants, others rabbits. Rabbit hunting is a much more reliable pursuit.” You may not become the hero of the village, but you will feed your family. That’s swing trading for you, and this is why this book, without claiming to be a complete guide to trading, focuses on swing trading.

[Return to the top](#)

Stops, targets, and risk control

Using protective stops is essential for your survival and long-term success. One of the main reasons so many traders lose and wash out of the markets is that they don’t use stops. We like thinking about profits, but you’ve got to know what is the maximum amount you can lose in a trade. Without that limit, you can irreparably damage your account.

People don’t use stops for three reasons: ignorance, wanting to hang on to hope, and the trouble with whipsaws.

As you approach the end of this book, ignorance should no longer be an issue. You know better than to waste money hoping that a sinking stock will miraculously reverse and rally. Whipsaws, on the other hand, are a real problem.

A whipsaw means that you buy a stock, set a stop underneath, the stock declines and hits it; you exit with a loss, only to see your stock reverse and rally just as you originally expected. After several whipsaws many folks give up using stops. But trading without stops is a recipe for a disaster because sooner or later, one of your ‘stopless’ stocks will get caught in a major

downdraft and deliver a ‘shark bite’ to your account.

Even though we can never completely eliminate whipsaws, we do have ways of reducing their occurrences.

Stops are a pain – but a disciplined trader accepts that pain just like a professional athlete accepts the pain of never-ending workouts. What we need to do is make our stops more logical and less likely to be hit by random moves. This will reduce the frequency of whipsaws. That’s what discipline is about: you put your hand out where it can be slapped, but you do it on your terms. An undisciplined trader spares himself the occasional slaps of whipsaws, but loses his arm to a shark bite of a disastrous loss.

There are chapters on various ways of setting stops in my books *The New Trading for a Living* and *The New Sell and Sell Short*. Let me condense them into two essential principles.

One: don’t place your stops at obvious levels. Crowds of lazy and unimaginative traders plop their stops immediately underneath recent lows. The market often sinks back to those obvious lows, triggers their stops, then reverses and rallies again. That’s why false breakouts, which we’ve discussed, are so common in the markets.

Place your stops at non-obvious levels – either closer to the market or deeper below the low. A closer stop will reduce your dollar risk per share but increase the risk of a whipsaw. A deeper stop will help you sidestep some false breakouts, but if it gets hit you’ll lose more. For short-term swing trading, it generally pays to place your stops tighter, while for longer-term position trades you’d be better off with wider stops. Remember ‘the iron triangle of risk control’ – a wider stop will force you to trade a smaller size.

Two: be sure to measure your stock’s volatility in deciding where to place your stop. A very practical tool is ATR (Average True Range). This indicator shows what distance your stock is likely to cover from one day to the next. There is an article on ATR in StockCharts’ ChartSchool and a chapter in my book *The New Trading for a Living*.

StockCharts makes it easy to look up the current ATR value. Create a new SharpChart and then find the “Indicators” area below the chart. Click on one of the unused dropdowns (“-None-“) and select “Avg. True Range (ATR)” from the list that appears. (I also like to change the Parameter setting from “14” to “26” but that depends on your time frame.) Finally, click “Update.” You’ll see a curve that rises and falls with your stock’s volatility. The number at the right edge is the current ATR value.

You definitely want to put your stop more than one ATR below your entry point. One ATR is the normal range of market noise, and if you jam your stop any closer, you’ll be asking for a whipsaw. One and a half ATR is the minimum distance from the entry to stop, two ATR even better. The farther away your stop, the lower your risk of a whipsaw but the higher your dollar risk per share. That’s where the Iron Triangle of Risk Control comes in, reducing the permitted number of shares when your risk per share increases. This way you can keep your total risk per trade within a predetermined limit.

As for the profit targets, use value zone and channel lines, as shown repeatedly in previous chapters. If you buy at a certain distance below the value zone and catch an uptrend, expect the pendulum of the market to swing a similar distance above value. If your analysis is strongly bullish, make the upper channel line your profit target.

[Return to the top](#)

Your visual diary

As we approach the end of this book, I’d like to return to the theme with which we began our journey. Being mindful and keeping good records will help you become a successful trader. This is why it is essential to keep a diary of your trades, documenting your entries and exits and reviewing those charts to learn what you did right or wrong.

There are many ways of keeping a visual diary, and StockCharts allows you to draw and write notes on your charts, then save them for future review. You can create a folder, call it My

Trades, and put those saved charts into it. Name them using the ticker, date and action, for example AAPL_20150126_Entry or FB_20150128_Exit.

Let's return to the very first stock we looked at in this book, whose numerical record appeared in Figure 02. Now, here's the diary of my AMT swing trade. I made my strategic decision to buy on a weekly chart and tactical decisions to enter and exit on the daily charts. I exited this trade in two steps, a day apart. Here it is:

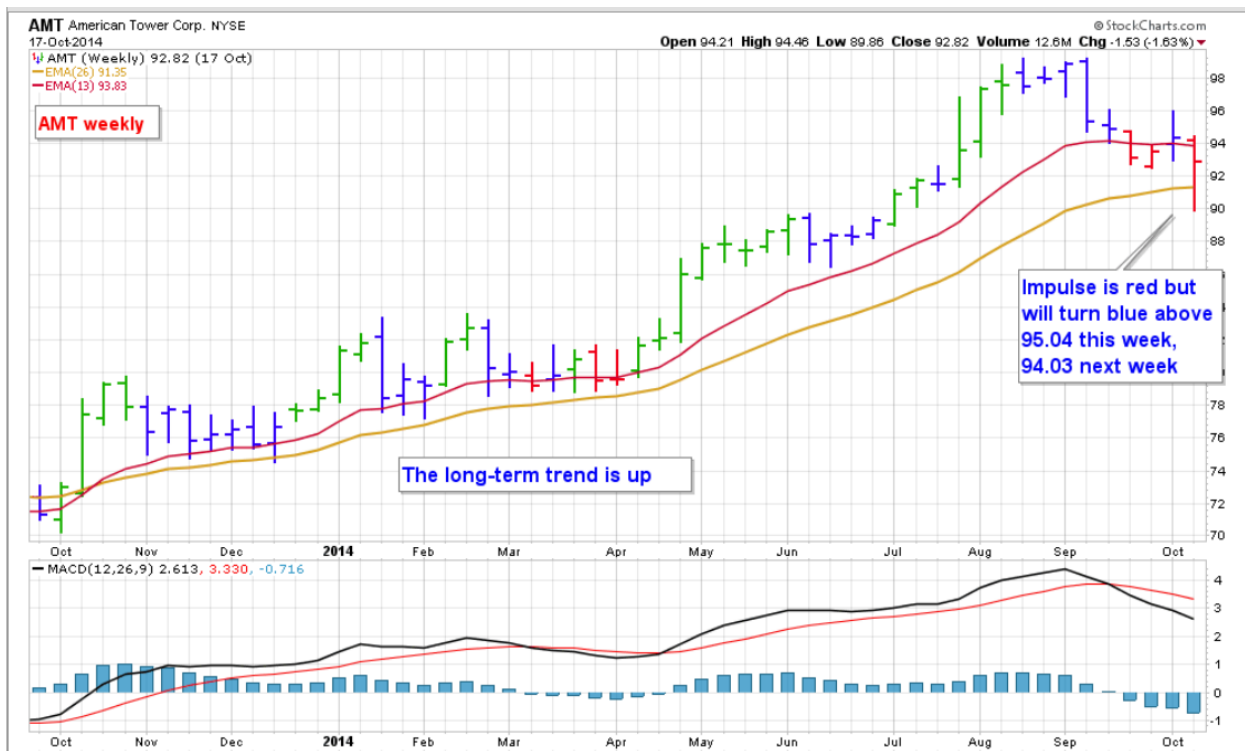


Figure 34. AMT weekly – diary of an entry.

The weekly chart shows a strong uptrend. At the right edge there is a pullback into the value zone.



Figure 35. AMT daily – diary of an entry.

Planned entry was \$92.52, target \$97, stop-loss \$91.12 (reward-to-risk ration of 3.2). Note that I entered before the weekly Impulse turned blue. I did it because the daily signals looked perfect and the stock was moving in the right direction, protected by a stop.



Figure 36. AMT daily – diary of an exit.

I exited this trade in two steps: first half on the third day and the rest on the fourth, as prices seemed to stall near their recent top. I bought below value and sold above the value zone in a swing trade that earned several thousand dollars (see Figure 02), without too much exposure to the markets. The next time I see this pattern, I'll do exactly the same thing.

I'm writing this chapter several months after closing my AMT trade. Do you think that without these charts I could remember any details? No, of course not – but my records enable me to go back in time and see everything as fresh as it was on the day I traded. I can review my decisions and learn from my actions. A trader who keeps good records becomes his own teacher. You cannot buy that – but you can get it for free, with your own labor.

[Return to the top](#)

The road ahead

Trading is a never-ending journey. It offers great rewards, but demands focus, attention, and discipline. It is also a huge amount of fun – especially when you do it right. I enjoyed creating this book, and hope that you enjoyed our journey together.

You, as a StockCharts user, have a great tool at your fingertips, with many more features that we covered in this book. Explore them, use them, but don't get carried away. There is less to trading than meets the eye, and you need a system that is relatively simple and robust.

There are several excellent market analysts associated with StockCharts. As a Member, you'll be receiving their emails. Select one or two you especially like and read their posts on a regular basis.

Be sure to continue your education. You may wish to read the books mentioned below. You definitely want to review their [instructional videos](#). Be sure to keep and review your trade diary. Take part in StockCharts webinars, and if at all possible, take yourself to their ChartCon conference in Seattle – it is an amazing experience.

Continue to work, and I look forward to hearing from you about your success one of these days.

Best wishes,

Dr. Alexander Elder

Vermont, March 2015

[Return to the top](#)

Sources

Elder, Alexander. *Entries & Exits* (New York: John Wiley & Sons, 2006).

———. *Force Index video* (New York: Elder.com, Inc., 2010).

———. *The New Sell & Short: How to Take Profits, Cut Losses and Benefit from Price Declines* (New York: John Wiley & Sons, 2011).

———. *The New Trading for a Living* (New York: John Wiley & Sons, 2014).

———. *Two Roads Diverged: Trading Divergences* (New York: Elder.com, 2012).

Lefevre, Edwin. *Reminiscences of a Stock Operator* (1923). (Greenville, SC: Traders Press, 1985).

Schroeder, Alice. *The Snowball: Warren Buffett and the Business of Life* (Bantam, 2009)

Murphy, John J. *Technical Analysis of the Financial Markets* (New York: New York Institute of Finance, 1999).

[Return to the top](#)

Acknowledgments

I am grateful to colleagues and friends without whose help this book might not have seen the light of day. I wish I could also blame them for any mistakes, but – kidding aside – I know it's me who is responsible; please let me know if you find any.

Chip Anderson at StockCharts.com encouraged me to take on this project and provided valuable technical assistance.

Kerry Lovvorn and Philip Wu generously shared their systems using StockCharts.

Konrad Krupinski, my former webmaster and now a physician, helped with cover design.

As always, at the end of any project, there was Carol Keegan Kayne – reviewing the text, catching errors, and helping make this file ready for readers. At the final step before releasing this file, Betsey Park did a much appreciated edit.

Thank you all!

Alexander Elder

Vermont, 2015

[Return to the top](#)

About the author

Dr. Alexander Elder is a professional trader and a teacher of traders. He is the author of 14 books, including *Trading for a Living* (1993) and *Come into My Trading Room* (Barron's 2002 Book of the Year), considered modern classics among traders.

Dr. Elder was born in Leningrad and grew up in Estonia, where he entered medical school at the age of 16. At 23, while working as a ship's doctor, he jumped a Soviet ship in Africa and received political asylum in the United States. He worked as a psychiatrist in New York City and taught at Columbia University. His experience as a psychiatrist provides him with unique insight into the psychology of trading. Dr. Elder's books, articles, and software reviews have established him as one of today's leading experts on trading.

Dr. Elder is the founder of [SpikeTrade](#) whose members compete for best stock picks each week. He is an active trader and a sought-after speaker at conferences in the US and abroad.

[Return to the top](#)